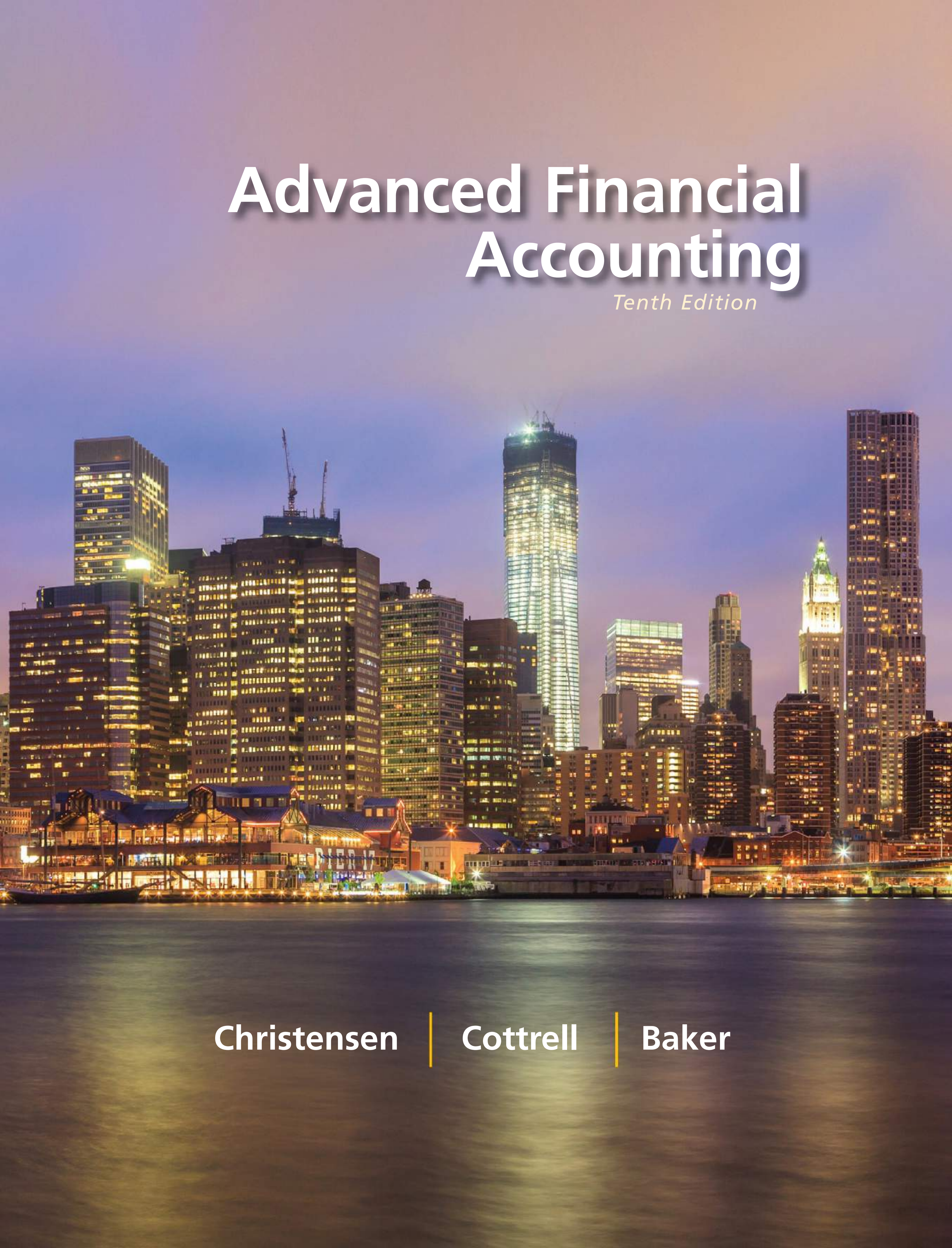
Advanced Financial Accounting

Tenth Edition



Christensen | Cottrell | Baker

Chapter Two

Reporting Intercorporate Investments and Consolidation of Wholly Owned Subsidiaries with No Differential

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BERKSHIRE HATHAWAY'S MANY INVESTMENTS

As of this writing (March 2012), Warren Buffett is the third richest man in the world, worth a staggering $44 billion. He is also the chairman, CEO, and primary shareholder of Berkshire Hathaway Inc. Over the past 46 years, Berkshire has grown at an average rate of 20.3 percent annually. Warren Buffett has achieved this success through his unparalleled business sense regarding investments and acquisitions of other companies.

Berkshire Hathaway was originally a textile manufacturing company. In 1962, Warren Buffett and his partners began buying large blocks of Berkshire stock. Within five years, Buffett began expanding into the insurance industry, and in 1985 the last of Berkshire's textile operations was shut down. In the late 1970s, Berkshire began acquiring stock in GEICO insurance and in January 1996 bought GEICO outright. While Berkshire has extensive insurance holdings, it has not focused its investment activities solely on insurance. Since Buffett took the helm in the 1960s, Berkshire has made many acquisitions. Look at the list of selected Berkshire holdings as of the end of 2011 (on the next page). Do you recognize any of these companies?

Each item in Berkshire's portfolio has to be accounted for individually. For example, Comdisco Holdings and The Washington Post Company are accounted for as equity method investments, while Walmart and American Express are classified as available-for-sale investments. Berkshire consolidates the fully owned companies such as Wesco Financial and See's Candies. In addition, companies like GEICO have many subsidiaries of their own. As you can imagine, accounting for investments at Berkshire can be very complex. This chapter focuses on issues related to the accounting for investments.

BERKSHIRE HATHAWAY INC.

BERKSHIRE HATHAWAY SELECTED HOLDINGS
(as of 12/31/2011)

Fully owned subsidiaries:

GEICO
Dairy Queen
See's Candies
Fruit of the Loom
BNSF Railway
The Pampered Chef
Wesco Financial Corporation

Partially owned companies:	**Ticker**	**Holding Value**	**Stake**
Comdisco Holdings Company	CDCO	$ 13,076,204	38.2%
The Washington Post Company	WPO	$ 679,737,306	22.4%
American Express	AXP	$ 8,033,850,993	13.0%
Moody's	MCO	$ 1,106,489,835	12.8%
The Coca-Cola Company	KO	$13,836,000,000	8.8%
Wells Fargo	WFC	$12,002,249,483	7.3%
International Business Machines	IBM	$12,705,138,142	5.4%
Kraft Foods	KFT	$ 3,329,077,772	4.9%
US Bancorp	USB	$ 2,020,783,999	3.6%
Procter & Gamble	PG	$ 5,117,991,620	2.8%
ConocoPhillips	COP	$ 2,259,687,758	2.3%
Walmart	WMT	$ 2,303,581,749	1.1%
Johnson & Johnson	JNJ	$ 1,879,504,085	1.1%
Costco	COST	$ 373,665,891	1.0%
United Parcel Service Inc.	UPS	$ 109,390,968	0.2%
General Electric	GE	$ 147,546,763	0.1%

LEARNING OBJECTIVES

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

- LO 2-1 Understand and explain how ownership and control can influence the accounting for investments in common stock.
- LO 2-2 Prepare journal entries using the cost method for accounting for investments.
- LO 2-3 Prepare journal entries using the equity method for accounting for investments.
- LO 2-4 Understand and explain differences between the cost and equity methods.
- LO 2-5 Prepare journal entries using the fair value option.
- LO 2-6 Make calculations and prepare basic elimination entries for a simple consolidation.
- LO 2-7 Prepare a consolidation worksheet.

ACCOUNTING FOR INVESTMENTS IN COMMON STOCK

LO 2-1

Understand and explain how ownership and control can influence the accounting for investments in common stock.

Companies acquire ownership interests in other companies for a variety of reasons. For example, some companies invest in other companies simply to earn a favorable return by taking advantage of the future earnings potential of their investees. Other reasons for acquiring interests in other entities include (1) gaining voting control, (2) entering new product markets by purchasing companies already established in those areas, (3) ensuring a supply of raw materials or other production inputs, (4) ensuring a customer for production output, (5) gaining economies associated with greater size, (6) diversifying operations, (7) obtaining new technology, (8) lessening competition, and (9) limiting risk.

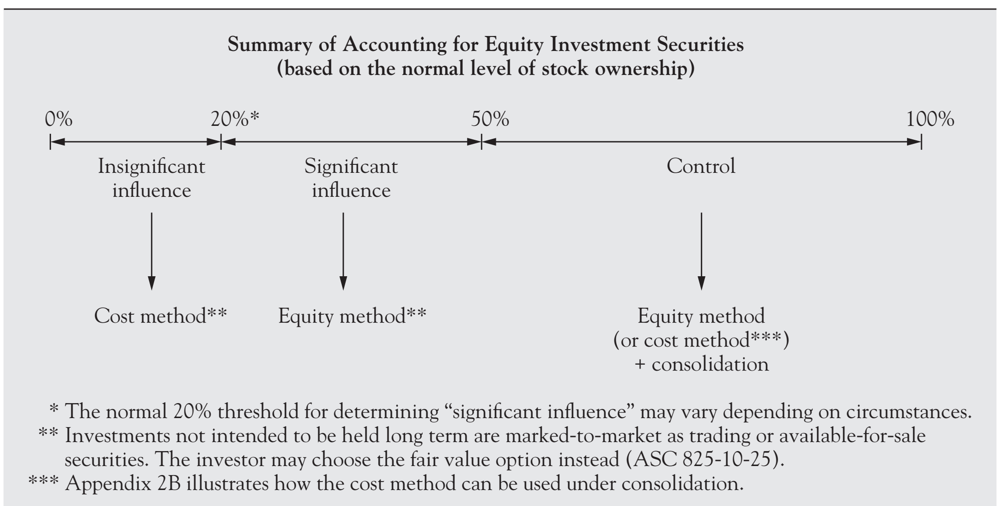
The method used to account for investments in common stock depends, in part, on the level of influence or control that the investor is able to exercise over the investee. The investment must be reported on the investor's balance sheet using the cost method (adjusted to market value, if appropriate), the equity method, or the fair value option. Note that, while use of the cost or equity method is dictated by the level of influence, the investor can elect the fair value option in place of either method. Figure 2–1 summarizes the relationship between methods used to report intercorporate investments in common stock and levels of ownership and influence.

The ***cost method*** is used for reporting investments in equity securities when both consolidation and equity-method reporting are inappropriate. If cost-method equity securities have readily determinable fair values, they must be adjusted to market value at year-end under **ASC 320-10-30-2.**[1] Under the cost method, the investor recognizes income from the investment when the income is distributed by the investee as dividends.

The ***equity method*** is used for external reporting when the investor exercises ***significant influence*** over the operating and financial policies of the investee and consolidation is not appropriate. This method is used most often when one company holds 20 percent or more of another company's common stock. Under the equity method, the investor recognizes income from the investment as the investee earns the income. Instead of combining the individual assets, liabilities, revenues, and expenses of the investee with those of the investor, as in consolidation, the investment is reported as one line in the investor's balance sheet, and income recognized from the investee is reported as one line in the investor's income statement. The investment represents the investor's share of the investee's net assets, and the income recognized is the investor's share of the investee's net income.

For financial reporting, consolidated financial statements that include both the investor and the investee must be presented if the investor can exercise ***control*** over the investee. ***Consolidation*** involves combining for financial reporting the individual assets, liabilities, revenues, and expenses of two or more related companies as if they were part of a single company. This process includes the elimination of all intercompany ownership and activities. Consolidation normally is appropriate when one company, referred to as the ***parent,*** controls another company, referred to as a ***subsidiary.*** We discuss the specific requirements

FIGURE 2–1
Financial Reporting Basis by Level of Common Stock Ownership



[1] Because the provisions of **ASC 320-10-30-2** are normally discussed in Intermediate Accounting, detailed coverage is not provided here. Note, however, that equity investments accounted for using the cost method are accounted for as discussed in this chapter, with the provisions of **ASC 320-10-30-2** applied as end-of-period adjustments. **ASC 320-10-30-2** is not applicable to equity-method investments.

for consolidation later in this chapter. A subsidiary that is not consolidated with the parent is referred to as an ***unconsolidated subsidiary*** and is shown as an investment on the parent's balance sheet. Under current accounting standards, most subsidiaries are consolidated. When intercorporate investments are consolidated for financial reporting, the investment and related income accounts are eliminated in preparing the consolidated financial statements. Nevertheless, the parent must still account for the investments on its books. Parent companies normally account for investments in consolidated subsidiaries on their books using the equity method.[2]

Under the fair value option **(ASC 825-10-25)**, companies have the choice of using traditional methods, such as the cost and equity methods, to report financial assets and liabilities, or they can elect to report some or all of their financial assets and liabilities at fair value. Under the fair value option, intercorporate investments in common stock are remeasured to fair value at the end of each period, and the unrealized gain or loss is recognized in income. The fair value option does not apply to intercorporate investments that must be consolidated.

This chapter follows Figure 2–1 in summarizing the accounting for investments in other companies. It first discusses the cost and equity methods for accounting for investments. It then summarizes the fair value option. Finally, it introduces the preparation of consolidated financial statements using the most simple consolidation scenario (when a subsidiary is wholly owned and it is either created or purchased for an amount exactly equal to the book value of the subsidiary's net assets). Since consolidation is a major topic of this textbook, we use a building block approach to our coverage of consolidation in Chapters 2 through 5. Chapter 3 explains how the basic consolidation process changes when the parent company owns less than 100 percent of the subsidiary. Chapter 4 shows how the consolidation process differs when the parent company acquires the subsidiary for an amount greater (or less) than the book value of the subsidiary's net assets. Finally, Chapter 5 presents the most complex consolidation scenario (where the parent owns less than 100 percent of the subsidiary's outstanding voting stock and the acquisition price is not equal to the book value of the subsidiary's net assets). Chapters 6 through 10 delve into asset transfers among members of the same consolidated group of companies and additional details related to consolidation.

Summary of Consolidation Coverage in Chapters 2–5

	Wholly Owned Subsidiary	Partially Owned Subsidiary
Investment = Book value	Chapter 2	Chapter 3
Investment > Book value	Chapter 4	Chapter 5

THE COST METHOD

LO 2-2

Prepare journal entries using the cost method for accounting for investments.

Intercorporate investments reported on the balance sheet using the cost method are carried by the investor at historical cost. Income is recorded by the investor as dividends are declared by the investee. The cost method is used when the investor lacks the ability either to control or to exercise significant influence over the investee. The inability of an investor

[2] The cost method is also allowed for consolidated investments since (as explained later in this chapter) the investment account is eliminated in the consolidated financial statements.

to exercise either control or significant influence over an investee may result from the size of the investment, usually at common stock ownership levels of less than 20 percent. In some situations, other factors, such as the bankruptcy of the investee, prevent the investor from exercising control or significant influence regardless of the size of the investment. (See Appendix 2A for a discussion of additional factors that may influence the use of the cost or equity methods.)

Accounting Procedures under the Cost Method

The cost method is consistent with the treatment normally accorded noncurrent assets. At the time of purchase, the investor records its investment in common stock at the total cost incurred in making the purchase. Subsequently, the carrying amount of the investment remains unchanged under the cost method; the investment continues to be carried at its original cost until the time of sale. Income from the investment is recognized by the investor as dividends are declared by the investee. Once the investee declares a dividend, the investor has a legal claim against the investee for a proportionate share of the dividend, and realization of the income is considered certain enough to be recognized. Recognition of investment income before a dividend declaration is considered inappropriate because the investee's income is not available to the owners until a dividend is declared.

To illustrate the cost method, assume that ABC Company purchases 20 percent of XYZ Company's common stock for $100,000 at the beginning of the year but does not gain significant influence over XYZ. During the year, XYZ has net income of $60,000 and declares dividends of $20,000. Assuming the dividend is paid later, ABC Company records the following entries relating to its investment in XYZ:

(1)	Investment in XYZ Company Stock	100,000	
	Cash		100,000
	Record purchase of XYZ Company stock.		
(2)	Dividends Receivable	4,000	
	Dividend Income		4,000
	Record dividend declared by XYZ Company ($20,000 × 0.20).		

Note that ABC records only its share of XYZ's distributed earnings and makes no entry for the undistributed portion. The carrying amount of the investment is still the original cost of $100,000.

Declaration of Dividends in Excess of Earnings since Acquisition

A special treatment is required under the cost method in situations in which an investor holds common stock in a company that declares dividends in excess of the cumulative income it has earned since the investor acquired its stock. The dividends received are viewed first as representing earnings of the investee from the purchase date of the investment to the dividend declaration date. All dividends declared by the investee in excess of its earnings since acquisition by the investor are viewed by the investor as ***liquidating dividends.*** The investor's share of these liquidating dividends is treated as a return of capital, and the investment account balance is reduced by that amount. Blocks of an investee's stock acquired at different times should be treated separately for purposes of computing liquidating dividends.

Liquidating Dividends Example

To illustrate the computation of liquidating dividends received by the investor, assume that Investor Company purchases 10 percent of the common stock of Investee Company on January 2, 20X1. The annual income and dividends of Investee, the amount of dividend income recognized by Investor each year under the cost method, and the reduction of the carrying amount of Investor's investment in Investee when appropriate are as follows:

	Investee Company			Investor Company		
Year	**Net Income**	**Dividends**	**Cumulative Undistributed Income**	**Cash Received**	**Dividend Income**	**Reduction of Investment**
20X1	$100,000	$ 70,000	$30,000	$ 7,000	$ 7,000	
20X2	100,000	120,000	10,000	12,000	12,000	
20X3	100,000	120,000	0	12,000	11,000	$1,000
20X4	100,000	120,000	0	12,000	10,000	2,000
20X5	100,000	70,000	30,000	7,000	7,000	

Investor Company records its 10 percent share of Investee's dividend as income in 20X1 because the income of Investee exceeds its dividend. In 20X2, Investee's dividend exceeds earnings for the year, but the cumulative dividends declared since January 2, 20X1, the date Investor acquired Investee's stock, do not exceed Investee's earnings since that date. Hence, Investor again records its 10 percent share of the dividend as income. By the end of 20X3, dividends declared by Investee since January 2, 20X1, total $310,000 while Investee's income since that date totals only $300,000. Thus, from Investor's point of view, $10,000 of the 20X3 dividend represents a return of capital while the remaining $110,000 represents a distribution of earnings. Investor's share of each amount is 10 percent. The entry to record the 20X3 dividend on Investor's books is:

(3)	Cash	12,000	
	Investment in Investee		1,000
	Dividend Income		11,000

Record receipt of 20X3 dividend from Investee.
$12,000 = $120,000 × 0.10.
$1,000 = ($310,000 − $300,000) × 0.10.
$11,000 = ($120,000 − $10,000) × 0.10.

Once the investor has recorded a liquidating dividend, the comparison in future periods between cumulative earnings and dividends of the investee should be based on the date of the last liquidating dividend rather than the date the investor acquired the investee's stock. In this example, Investor Company records liquidating dividends in 20X3 and 20X4. In years after 20X4, Investor compares earnings and dividends of Investee from the date of the most recent liquidating dividend in 20X4 rather than comparing from January 2, 20X1. Investor considers the entire dividend paid in 20X5 to be a distribution of earnings.

Liquidating Dividends following Switch from Equity Method

If the investor previously carried the investment using the equity method and, because of the sale of a portion of the investment, switches to the cost method, the date of the switch in methods replaces the date of acquisition as the reference date for distinguishing liquidating dividends. From that point forward, the investor should compare earnings and dividends of the investee starting at the date of the switch to the cost method.

Acquisition at Interim Date

The acquisition of an investment at other than the beginning or end of a fiscal period generally does not create any major problems when the cost method is used to account for the investment. The only potential difficulty involves determining whether some part of the payment received by the investor is a liquidating dividend when the investee declares a dividend soon after the investor purchases stock in the investee. In this situation, the investor must estimate the amount of the investee's earnings for the portion of the period during which the investor held the investee's stock and may record dividend income only on that portion.

Changes in the Number of Shares Held

Changes in the number of investment shares resulting from stock dividends, stock splits, or reverse splits receive no formal recognition in the accounts of the investor. The carrying value of the investment before the stock dividend or split becomes the carrying amount of the new, higher or lower number of shares. Purchases and sales of shares, of course, do require journal entries but do not result in any unusual difficulties under the cost method.

Purchases of Additional Shares

The purchase of additional shares of a company already held is recorded at cost in the same way as an initial purchase of shares. The investor's new percentage ownership of the investee then is calculated, and other evidence, if available, is evaluated to determine whether the total investment still should be carried at cost or if the investor should switch to the equity method. When the additional shares give the investor the ability to exercise significant influence over the investee, the equity method should be applied retroactively from the date of the original investment, as illustrated later in this chapter.

Sales of Shares

If a company sells all or part of an intercorporate investment in stock, the transaction is accounted for in the same manner as the sale of any other noncurrent asset. A gain or loss on the sale is recognized for the difference between the proceeds received and the carrying amount of the investment sold.

If shares of the stock have been purchased at more than one price, a determination must be made at the time of sale as to which of the shares have been sold. The specific shares sold may be identified through segregation, numbered stock certificates, or other means. When specific identification is impractical, either a FIFO or weighted-average cost flow assumption may be used. However, the weighted-average method seldom is used in practice because it is not acceptable for tax purposes.

THE EQUITY METHOD

LO 2-3

Prepare journal entries using the equity method for accounting for investments.

The equity method of accounting for intercorporate investments in common stock is intended to reflect the investor's changing equity or interest in the investee. This method is a rather curious one in that the balance in the investment account generally does not reflect either cost or market value, and it does not necessarily represent a pro rata share of the investee's book value. Instead, the investment is recorded at the initial purchase price and adjusted each period for the investor's share of the investee's profits or losses and the dividends declared by the investee.

Use of the Equity Method

ASC 323-10-30 requires that the equity method be used for reporting investments in common stock of the following:

1. Corporate joint ventures. A ***corporate joint venture*** is a corporation owned and operated by a small group of businesses, none of which owns a majority of the joint venture's common stock.
2. Companies in which the investor's voting stock interest gives the investor the "ability to exercise significant influence over operating and financial policies" of that company.

The second condition is the broader of the two and establishes the "significant influence" criterion. Because assessing the degree of influence may be difficult in some cases, **ASC 323-10-15** establishes a 20 percent rule. In the absence of evidence to the contrary, an investor holding 20 percent or more of an investee's voting stock is presumed to have the ability to exercise significant influence over the investee. On the other hand, an investor holding less than 20 percent of an investee's voting stock is presumed not to have the ability to exercise significant influence in the absence of evidence to the contrary.

In most cases, an investment of 20 percent or more in another company's voting stock is reported under the equity method. Notice, however, that the 20 percent rule does not apply if other evidence is available that provides a better indication of the ability or inability of the investor to significantly influence the investee.

Regardless of the level of ownership, the equity method is not appropriate if the investor's influence is limited by circumstances other than stock ownership, such as bankruptcy of the investee or severe restrictions placed on the availability of a foreign investee's earnings or assets by a foreign government.

Investor's Equity in the Investee

Under the equity method, the investor records its investment at the original cost. This amount is adjusted periodically for changes in the investee's stockholders' equity occasioned by the investee's profits, losses, and dividend declarations. The effect of the investee's income, losses, and dividends on the investor's investment account and other accounts can be summarized as follows:

Reported by Investee	Effect on Investor's Accounts
Net income	Record income from investment Increase investment account
Net loss	Record loss from investment Decrease investment account
Dividend declaration	Record asset (cash or receivable) Decrease investment account

Recognition of Income

Under the equity method, the investor's income statement includes the investor's proportionate share of the investee's income or loss each period. The carrying amount of the investment is adjusted by the same amount to reflect the change in the net assets of the investee resulting from the investee's income.

To illustrate, assume that ABC Company acquires significant influence over XYZ Company by purchasing 20 percent of XYZ's common stock for $100,000 at the beginning of the year.

(4)	Investment in XYZ Company Stock	100,000	
	Cash		100,000

Record purchase of XYZ Company stock.

XYZ reports income of $60,000 for the year. ABC records its 20 percent share of XYZ's income ($12,000) in an account called "Income from XYZ Company" as follows:

(5)	Investment in XYZ Company Stock	12,000	
	Income from XYZ Company		12,000

Record income from XYZ Company ($60,000 × 0.20).

This entry may be referred to as the ***equity accrual*** and normally is made as an adjusting entry at the end of the period. If the investee reports a loss for the period, the investor recognizes its share of the loss and reduces the carrying amount of the investment by that amount.

Because of the ability to exercise significant influence over the policies of the investee, realization of income from the investment is considered to be sufficiently ensured to warrant recognition by the investor as the investee earns the income. This differs from the case in which the investor does not have the ability to significantly influence the investee and the investment must be reported using the cost method; in that case, income from the investment is recognized only upon declaration of a dividend by the investee.

Recognition of Dividends

Dividends from an investment are not recognized as income under the equity method because the investor's share of the investee's income is recognized as the investee earns it. Instead, the investee's dividends are viewed as distributions of previously recognized income that already has been capitalized in the carrying amount of the investment. The investor must consider investee dividends declared as a reduction in its equity in the investee and, accordingly, reduce the carrying amount of its investment. In effect, all dividends from the investee are treated as liquidating dividends under the equity method. Thus, if ABC Company owns 20 percent of XYZ Company's common stock and XYZ declares a $20,000 dividend, the following entry is recorded on ABC's books to record its share of the dividend:

(6)	Dividends Receivable	4,000	
	Investment in XYZ Company Stock		4,000

Record dividend from XYZ Company ($20,000 × 0.20).

The following T-accounts summarize all of the normal equity method entries (journal entries 4–6) on the investor company's books:

	Investment in XYZ Company			Income from XYZ Company		
Purchase	100,000					
20% of NI	12,000				12,000	20% of NI
		4,000	20% of Dividend			
Ending Balance	108,000				12,000	Ending Balance

While the "Investment in XYZ Company" account summarizes ABC's ownership of the net assets of XYZ Company, the "Income from XYZ" account summarizes ABC's share of XYZ Company's income.

Comparison of the Carrying Amount of the Investment and Investment Income under the Cost and Equity Methods

Because the investment account on the investor's books under the equity method is adjusted for the investor's share of the investee's income or losses and dividends, the carrying amount of the investment usually is not the same as the original cost to the investor. Only if the investee pays dividends in the exact amount of its earnings will the carrying amount of the investment subsequent to acquisition be equal to its original cost.

To compare the change in the carrying amount of the investment under the equity method relative to the cost method, assume the same facts listed previously for ABC's 20 percent acquisition of XYZ's common stock. The carrying amount of the investment using the equity method at the end of the period is $108,000 ($100,000 + $12,000 − $4,000), compared to the original acquisition price of $100,000 under the cost method.

Investment income under the equity method (the balance in the "Income from XYZ" account) is $12,000 while investment income under the cost method is equal to dividend income, $4,000.

Acquisition at Interim Date

When a company purchases an investment, the investor begins accruing income from the investee under the equity method at the date of acquisition. The investor may not accrue income earned by the investee before the acquisition date of the investment. When the purchase occurs between balance sheet dates, the amount of income earned by the investee from the date of acquisition to the end of the fiscal period may need to be estimated by the investor in recording the equity accrual.

To illustrate, assume that ABC acquires 20 percent of XYZ's common stock on October 1 for $100,000. XYZ earns income of $60,000 uniformly throughout the year and declares dividends of $20,000 on December 20 (paid on December 31). The carrying amount of the investment is increased by $3,000, which represents ABC's share of XYZ's net income earned between October 1 and December 31 (1/4 of the year), and is decreased by $4,000 as a result of dividends declared at year-end (resulting in a net *decrease* of $1,000 since the time of the stock purchase).[3]

	Investment in XYZ Company			Investment in XYZ Company		
Stock Purchase	100,000					
20% × NI × 1/4	3,000				3,000	20% × NI × 1/4
		4,000	20% Dividends			
Ending Balance	99,000					

Changes in the Number of Shares Held

Some changes in the number of common shares held by an investor are handled easily under the equity method, but others require a bit more attention. A change resulting from a stock dividend, split, or reverse split is treated in the same way as under the cost method. No formal accounting recognition is required on the books of the investor. On the other hand, purchases and sales of shares do require formal recognition.

FYI

Figure 2–1 indicates that once a company owns more than 50% of the outstanding voting stock of an investee company, the parent company can account for the investment using the cost method on its own books because the investment account is eliminated in the consolidation process. Berkshire Hathaway's 2010 Form 10-K indicates: "As a result of our acquisition of the remaining outstanding stock of BNSF on February 12, 2010, we discontinued the use of the equity method and since that date, BNSF's accounts have been consolidated in our financial statements."

Purchases of Additional Shares

A purchase of additional shares of a common stock already held by an investor and accounted for using the equity method simply involves adding the cost of the new shares to the investment account and applying the equity method in the normal manner from the date of acquisition forward. The new and old investments in the same stock are combined for financial reporting purposes. Income accruing to the new shares can be recognized by the investor only from the date of acquisition forward.

To illustrate, assume that ABC Company purchases 20 percent of XYZ Company's common stock on January 2, 20X1, for $100,000, and another 10 percent on July 1, 20X1, for $50,000, and that the stock purchases represent 20 percent and 10 percent, respectively, of the book value of XYZ's net assets. If XYZ earns income of $25,000 from January 2 to June 30 and earns $35,000 from July 1 to December 31, the total income recognized in 20X1 by ABC from its investment in XYZ is $15,500, computed as follows:

[3] Note that we assume the entire dividend ($20,000) was declared and paid at the end of the year. If dividends had been declared and paid quarterly, we would record dividends declared only after ABC's acquisition of the XYZ shares.

Income, January 2 to June 30: $25,000 × 0.20	$ 5,000
Income, July 1 to December 31: $35,000 × 0.30	10,500
Investment Income, 20X1	$15,500

If XYZ declares and pays a $10,000 dividend on January 15 and again on July 15, ABC reduces its investment account by $2,000 ($10,000 × 0.20) on January 15 and by $3,000 ($10,000 × 0.30) on July 15. Thus, the ending balance in the investment account at the end of the year is $160,500, computed as follows:

	Investment in XYZ Company			Income from XYZ Company		
1/2/X1 Purchase	100,000					
20% NI to 6/30	5,000	2,000	20% Div. to 6/30		5,000	20% NI to 6/30
7/1/X1 Purchase	50,000					
30% NI from 7/1	10,500	3,000	30% Div. from 7/1		10,500	30% NI from 7/1
Ending Balance	160,500				15,500	Ending Balance

When an investment in common stock is carried using the cost method and purchases of additional shares give the investor the ability to significantly influence the investee, a retroactive switch from the cost method to the equity method is required. This change to the equity method must be applied retroactively to the date of the first acquisition of the investee's stock.

To illustrate a change to the equity method, assume that Aron Corporation purchases 15 percent of Zenon Company's common stock on January 2, 20X1, and another 10 percent on January 2, 20X4. Furthermore, assume that Aron switches to the equity method on January 2, 20X4, because it gains the ability to significantly influence Zenon. Given the following income and dividend data for Zenon, and assuming that the purchases of stock are at book value, the investment income figures reported by Aron originally and as restated are as follows:

	Zenon		**Aron's Reported Investment Income**	
Year	**Net Income**	**Dividends**	**Originally under Cost [a]**	**Restated under Equity [b]**
20X1	$15,000	$10,000	$1,500	$2,250
20X2	18,000	10,000	1,500	2,700
20X3	22,000	10,000	1,500	3,300
	$55,000	$30,000	$4,500	$8,250

[a]15 percent of Zenon's dividends for the year.

[b]15 percent of Zenon's net income for the year.

Thus, in Aron's 20X4 financial report, the comparative statements for 20X1, 20X2, and 20X3 are restated to include Aron's 15 percent share of Zenon's profit and to exclude from income Aron's share of dividends recognized under the cost method. In addition, Aron's investment account and retained earnings are restated as if the equity method had been applied from the date of the original acquisition. This restatement is accomplished on Aron's books with the following journal entry on January 2, 20X4:

(7)	Investment in Zenon Company Stock	3,750	
	Retained Earnings		3,750
	Restate investment account from cost to equity method: $8,250 − $4,500.		

In 20X4, if Zenon reports net income of $30,000, Aron's investment income is $7,500 (25 percent of Zenon's net income).

FYI

The summary of Berkshire Hathaway's holdings at the beginning of the chapter lists its stake in Moody's at 12.8%. Its holdings had previously exceeded 20%. However, Berkshire's 2009 10-K indicates: "As a result of a reduction in our ownership of Moody's in July of 2009, we discontinued the use of the equity method as of the beginning of the third quarter of 2009."

Sales of Shares

The sale of all or part of an investment in common stock carried using the equity method is treated the same as the sale of any noncurrent asset. First, the investment account is adjusted to the date of sale for the investor's share of the investee's current earnings. Then a gain or loss is recognized for the difference between the proceeds received and the carrying amount of the shares sold.

If only part of the investment is sold, the investor must decide whether to continue using the equity method to account for the remaining shares or to change to the cost method. The choice is based on evidence available after the sale as to whether the investor still is able to exercise significant influence over the investee. If the equity method no longer is appropriate after the date of sale, the carrying value of the remaining investment is treated as the cost of that investment, and the cost method is applied in the normal manner from the date of sale forward. No retroactive restatement of the investment to actual cost is made.

COMPARISON OF THE COST AND EQUITY METHODS[4]

LO 2-4

Understand and explain differences between the cost and equity methods.

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Figure 2–2 summarizes some of the key features of the cost and equity methods of accounting for intercorporate investments. The cost method is consistent with the historical cost basis for most other assets. This method is subject to the usual criticisms leveled against historical cost. In particular, questions arise as to the relevance of reporting the purchase price of an investment acquired some years earlier. The cost method conforms more closely to the traditional accounting and legal views of the realization of income in that the investee's earnings are not available to the investor until transferred as dividends. However, income based on dividend distributions can sometimes be manipulated. The significant influence criterion required for the equity method considers that the declaration of dividends by the investee can be influenced by the investor. Recognizing equity-method income from the investee without regard to

FIGURE 2–2
Summary Comparison of the Cost and Equity Methods

Item	Cost Method	Equity Method
Recorded amount of investment at date of acquisition	Original cost	Original cost
Usual carrying amount of investment subsequent to acquisition	Original cost	Original cost increased (decreased) by investor's share of investee's income (loss) and decreased by investor's share of investee's dividends
Income recognition by investor	Investor's share of investee's dividends declared from earnings since acquisition	Investor's share of investee's earnings since acquisition, whether distributed or not
Investee dividends from earnings since acquisition by investor	Income	Reduction of investment
Investee dividends in excess of earnings since acquisition by investor	Reduction of investment	Reduction of investment

[4] To view a video explanation of this topic, visit advancedstudyguide.com.

investee dividends provides protection against manipulating the investor's net income by influencing investee dividend declarations. On the other hand, the equity method is sometimes criticized because the asset valuation departs from historical cost but stops short of a market value approach. Instead, the carrying amount of the investment is composed of a number of components and is not similar to the valuation of any other assets.

Over the years, there has been considerable criticism of the use of the equity method as a substitute for the consolidation of certain types of subsidiaries. Although the equity method has been viewed as a ***one-line consolidation,*** the amount of detail reported is considerably different under the equity method than with consolidation. For example, an investor would report the same equity-method income from the following two investees even though their income statements are quite different in composition:

	Investee 1	Investee 2
Sales	$ 50,000	$ 500,000
Operating Expenses	(30,000)	(620,000)
Operating Income (Loss)	$ 20,000	$(120,000)
Gain on Sale of Land		140,000
Net Income	$ 20,000	$ 20,000

Similarly, an investment in the stock of another company is reported under the equity method as a single amount in the investor's balance sheet regardless of the investee's asset and capital structure. In the past, some companies borrowed heavily through unconsolidated subsidiaries and reported their investments in the subsidiaries using the equity method. Because the debt was not reported in these situations, concerns were raised over the use of the equity method to facilitate "off-balance sheet" financing.

As a result of these concerns, the Financial Accounting Standards Board eliminated the use of the equity method for reporting investments in subsidiaries by requiring the consolidation of virtually all majority-owned subsidiaries.

THE FAIR VALUE OPTION

LO 2-5

Prepare journal entries using the fair value option.

ASC 825-10-45 permits, but does not require, companies to measure many financial assets and liabilities at fair value. Companies holding investments in the common stock of other companies have this option for investments that are not required to be consolidated. Thus, rather than using the cost or equity method to report nonsubsidiary investments in common stock, investors may report those investments at fair value.

Under the fair value option, the investor remeasures the investment to its fair value at the end of each period. The change in value is then recognized in income for the period. Although the FASB does not specify how to account for dividends received from the investment, normally the investor recognizes dividend income in the same manner as under the cost method.

To illustrate the use of the fair value method, assume that Ajax Corporation purchases 40 percent of Barclay Company's common stock on January 1, 20X1, for $200,000. Ajax prepares financial statements at the end of each calendar quarter. On March 1, 20X1, Ajax receives a cash dividend of $1,500 from Barclay. On March 31, 20X1, Ajax determines the fair value of its investment in Barclay to be $207,000. During the first quarter of 20X1, Ajax records the following entries on its books in relation to its investment in Barclay:

(8)	Investment in Barclay Stock	200,000	
	Cash		200,000

Record purchase of Barclay Company stock.

(9)	Cash	1,500	
	Dividend Income		1,500
	Record dividend income from Barclay Company.		

(10)	Investment in Barclay Stock	7,000	
	Unrealized Gain on Barclay Stock		7,000
	Record increase in fair value of Barclay stock.		

OVERVIEW OF THE CONSOLIDATION PROCESS

LO 2-6

Make calculations and prepare basic elimination entries for a simple consolidation.

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The consolidation process adds together the financial statements of two or more legally separate companies, creating a single set of financial statements. Chapters 2 through 5 discuss the specific procedures used to produce consolidated financial statements in considerable detail. An understanding of the procedures is important because they facilitate the accurate and efficient preparation of consolidated statements. However, the focus should continue to be on the end product—the financial statements. The procedures are intended to produce financial statements that appear as if the consolidated companies are actually a single company.

The separate financial statements of the companies involved serve as the starting point each time consolidated statements are prepared. These separate statements are added together, after some adjustments and eliminations, to generate consolidated financial statements. The adjustments and eliminations relate to intercompany transactions and holdings. Although the individual companies within a consolidated entity may legitimately report sales and receivables or payables to one another, the consolidated entity as a whole must report transactions only with parties outside the consolidated entity and receivables from or payables to external parties. Thus, the adjustments and eliminations required as part of the consolidation process aim at ensuring that the consolidated financial statements are presented as if they were the statements of a single enterprise.

CONSOLIDATION PROCEDURES FOR WHOLLY OWNED SUBSIDIARIES THAT ARE CREATED OR PURCHASED AT BOOK VALUE

We begin preparing consolidated financial statements with the books of the individual companies that are to be consolidated. Because the consolidated entity has no books, all amounts in the consolidated financial statements originate on the books of the parent or a subsidiary or in the consolidation worksheet.

The term ***subsidiary*** has been defined as "an entity . . . in which another entity, known as its ***parent,*** holds a controlling financial interest **(ASC 810-10-20)**." A parent company may hold all or less than all of a corporate subsidiary's common stock, but at least majority ownership is normally required for the presentation of consolidated financial statements. Most, but not all, corporate subsidiaries are wholly owned by their parents.

Because most subsidiaries are wholly owned, this chapter begins the in-depth examination of consolidation procedures for wholly owned subsidiaries. Moreover, we begin with the most basic consolidation scenario when the subsidiary is either created by the parent or purchased for an amount exactly equal to the book value of the subsidiary's net assets. This assumption simplifies the consolidation because there is no differential. We start with basic consolidation procedures applied to the preparation of a consolidated balance sheet immediately following the establishment of a parent–subsidiary relationship, either through creation or acquisition of the subsidiary. Then we introduce the use of a simple consolidation worksheet for the balance sheet only. The chapter then moves to the preparation of a full set of consolidated financial statements in subsequent periods and the use of a three-part worksheet designed to facilitate the preparation of a consolidated income statement, retained earnings statement, and balance sheet.

CONSOLIDATION WORKSHEETS

LO 2-7

Prepare a consolidation worksheet.

The ***consolidation worksheet*** provides a mechanism for efficiently combining the accounts of the separate companies involved in the consolidation and for adjusting the combined balances to the amounts that would be reported if all consolidating companies were actually a single company. When consolidated financial statements are prepared, the account balances are taken from the separate books of the parent and each subsidiary and placed in the consolidation worksheet. The consolidated statements are prepared, after adjustments and eliminations, from the amounts in the consolidation worksheet.

Worksheet Format

In practice, companies use several different worksheet formats for preparing consolidated financial statements. One of the most widely used formats is the three-part worksheet, consisting of one part for each of three financial statements: (1) the income statement, (2) the statement of retained earnings, and (3) the balance sheet. In recent years, the retained earnings statement has been dropped by many companies in favor of the statement of changes in stockholders' equity. Nevertheless, the information normally found in a retained earnings statement is included in the statement of stockholders' equity, along with additional information, and so the three-part worksheet still provides a useful format. Figure 2–3 presents the format for the comprehensive three-part consolidation worksheet. Specifically, Figure 2–3 illustrates the basic form of a consolidation worksheet. The titles of the accounts of the consolidating companies are listed in the first column of the worksheet. The account balances from the books or trial balances of the individual companies are listed in the next set of columns, with a separate column for each company included in the consolidation. Entries are made in the columns labeled *Elimination Entries* to adjust or eliminate balances so that the resulting amounts are those that would appear in the financial statements if all the consolidating companies actually formed a single company. The balances in the last column are obtained by summing all amounts algebraically across the worksheet by account. These are the balances that appear in the consolidated financial statements.

The top portion of the worksheet is used in preparing the consolidated income statement. All income statement accounts are listed in the order they normally appear in an income

FIGURE 2–3
Format for Consolidation Worksheet

			Elimination Entries		
	Parent	Subsidiary	DR	CR	Consolidated
Income Statement					
Revenues					
Expenses					
Net Income					
Statement of Retained Earnings					
Retained Earnings (1/1)					
Add: Net Income					
Less: Dividends					
Retained Earnings (12/31)					
Balance Sheet					
Assets					
Total Assets					
Liabilities					
Equity					
Common Stock					
Retained Earnings					
Total Liabilities & Equity					

statement.[5] When the income statement portion of the worksheet is completed, a total for each column is entered at the bottom of the income statement portion of the worksheet. The bottom line in this part of the worksheet shows the parent's net income, the subsidiary's net income, the totals of the debit and credit eliminations for this section of the worksheet, and consolidated net income. The entire bottom line is carried down to the "net income" line in the retained earnings statement portion of the worksheet immediately below the income statement.

The retained earnings statement section of the worksheet is in the same format as a retained earnings statement, or the retained earnings section of a statement of stockholders' equity. Net income and the other column totals from the bottom line of the income statement portion of the worksheet are brought down from the income statement above. Similarly, the final line in the retained earnings statement section of the worksheet is carried down in its entirety to the retained earnings line in the balance sheet section.

The bottom portion of the worksheet reflects the balance sheet amounts at the end of the period.[6] The retained earnings amounts appearing in the balance sheet section of the worksheet are the totals carried forward from the bottom line of the retained earnings statement section. The examples in the following sections of this chapter demonstrate the use of the comprehensive three-part consolidation worksheet.

CAUTION

The most common error students commit in preparing the worksheet is forgetting to carry down the adjustments when they carry down net income from the income statement to the statement of retained earnings and when they carry down the retained earnings ending balance in the statement of retained earnings to the balance sheet.

Nature of Elimination Entries

Elimination entries are used in the consolidation worksheet to adjust the totals of the individual account balances of the separate consolidating companies to reflect the amounts that would appear if the legally separate companies were actually a single company. Elimination entries appear only in the consolidation worksheet and do not affect the books of the separate companies. These worksheet entries are sometimes called "elimination" entries or simply "consolidation" entries.

For the most part, companies that are to be consolidated record their transactions during the period without regard to the consolidated entity. Transactions with related companies tend to be recorded in the same manner as those with unrelated parties, although intercompany transactions may be recorded in separate accounts or other records may be kept to facilitate the later elimination of intercompany transactions. Each of the consolidating companies also prepares its adjusting and closing entries at the end of the period in the normal manner. The resulting balances are entered in the consolidation worksheet and combined to arrive at the consolidated totals. Elimination entries are used in the worksheet to increase or decrease the combined totals for individual accounts so that only transactions with external parties are reflected in the consolidated amounts.

Some elimination entries are required at the end of one period but not at the end of subsequent periods. For example, a loan from a parent to a subsidiary in December 20X1, repaid in February 20X2, requires an entry to eliminate the intercompany receivable and payable on December 31, 20X1, but not at the end of 20X2. Some other elimination entries need to be placed in the consolidation worksheets each time consolidated statements are prepared for a period of years. For example, if a parent company sells land to a subsidiary for $5,000 above the original cost to the parent, a worksheet entry is needed to reduce the basis of the land by $5,000 each time consolidated statements are prepared for as long as an **affiliate** (an affiliated company) holds the land.[7] It is important to remember that because elimination entries are not made on the books of any company, they do not carry over from period to period.

[5] An optional format lists accounts with credit balance accounts first and those having debit balances listed next.

[6] Optionally, accounts can be separated and listed with debits first and then credits.

[7] An affiliated company is one that is related to the company in question. For example, two corporations controlled by the same parent company would be considered affiliates.

CONSOLIDATED BALANCE SHEET WITH WHOLLY OWNED SUBSIDIARY

The simplest consolidation setting occurs when the financial statements of related companies are consolidated immediately after a parent–subsidiary relationship is established through a business combination or the creation of a new subsidiary. We present a series of examples to illustrate the preparation of a consolidated balance sheet. Consolidation procedures are the same whether a subsidiary is created or acquired. We use the case of an acquired subsidiary to illustrate the consolidation procedures in the examples that follow. In each example, Peerless Products Corporation purchases all of the common stock of Special Foods Inc. on January 1, 20X1, and immediately prepares a consolidated balance sheet. Figure 2–4 presents the separate balance sheets of the two companies immediately before the combination.

In the discussion that follows, we discuss all journal entries and worksheet elimination entries in the text of the chapter. To avoid confusing the elimination entries with journal entries that appear on the separate books of the parent or subsidiary, all worksheet elimination entries appearing in the text are shaded; journal entries recorded in the books of the parent company are not shaded.

100 Percent Ownership Acquired at Book Value

In the first example, Peerless acquires all of Special Foods' outstanding common stock for $300,000, an amount equal to the fair value of Special Foods as a whole. On the date of combination, the fair values of Special Foods' individual assets and liabilities are equal to their book values shown in Figure 2–4. Because Peerless acquires all of Special Foods' common stock and because Special Foods has only the one class of stock outstanding, the total book value of the shares acquired equals the total stockholders' equity of Special Foods ($200,000 + $100,000). The $300,000 of consideration exchanged is equal to the book value of the shares acquired. This ownership situation can be characterized as follows:

P → S (1/1/X1, 100%)

Fair value of consideration		$300,000
Book value of shares acquired		
Common stock—Special Foods	$200,000	
Retained earnings—Special Foods	100,000	
		300,000
Difference between fair value and book value		$ 0

FIGURE 2–4
Balance Sheets of Peerless Products and Special Foods, January 1, 20X1, Immediately before Combination

	Peerless Products	Special Foods
Assets		
Cash	$ 350,000	$ 50,000
Accounts Receivable	75,000	50,000
Inventory	100,000	60,000
Land	175,000	40,000
Buildings & Equipment	800,000	600,000
Accumulated Depreciation	(400,000)	(300,000)
Total Assets	$1,100,000	$500,000
Liabilities & Stockholders' Equity		
Accounts Payable	$ 100,000	$100,000
Bonds Payable	200,000	100,000
Common Stock	500,000	200,000
Retained Earnings	300,000	100,000
Total Liabilities & Equity	$1,100,000	$500,000

Peerless records the stock acquisition on its books with the following entry on the combination date:

(11)	Investment in Special Foods	300,000	
	Cash		300,000

Record the purchase of Special Foods stock.

Figure 2–5 presents the separate financial statements of Peerless and Special Foods immediately after the combination. Special Foods' balance sheet in Figure 2–5 is the same as in Figure 2–4, but Peerless' balance sheet has changed to reflect the $300,000 reduction in cash and the recording of the investment in Special Foods stock for the same amount. Note that the $300,000 of cash was paid to the former stockholders of Special Foods, not to the company itself. Accordingly, that cash is no longer in the consolidated entity. Instead, Peerless' balance sheet now reflects a $300,000 Investment in Special Foods Stock account.

Basic Elimination Entry

Figure 2–6 presents a basic example of a consolidation worksheet. The only elimination entry in the worksheet in Figure 2–6 removes the Investment in Special Foods Stock account and the subsidiary's stockholders' equity accounts. Although this elimination entry is very simple, to be consistent with the discussion of more complicated examples later in the chapter, we illustrate the thought process in developing the worksheet entry.

In this example, Peerless' investment is exactly equal to the book value of equity of Special Foods. Therefore, no goodwill is recorded and all assets and liabilities are simply combined from Special Foods' financial statements at their current book values. In Chapters 4 and 5, we will explore situations in which the acquiring company pays more than the book value of the acquired company's net assets (i.e., when there is a positive differential). However, in Chapters 2 and 3, the excess value of identifiable net assets and goodwill will always be equal to zero. To maintain a consistent approach through all four chapters, we always illustrate the components of the acquiring company's investment, even though it will always be exactly equal to its share of the book value of net assets in Chapters 2 and 3. Therefore, the relationship between the fair value of the consideration given to acquire Special Foods, the fair value of

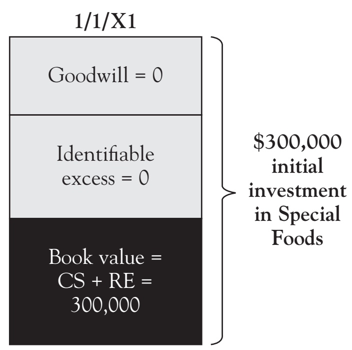
FIGURE 2–5
Balance Sheets of Peerless Products and Special Foods, January 1, 20X1, Immediately after Combination

	Peerless Products	Special Foods
Assets		
Cash	$ 50,000	$ 50,000
Accounts Receivable	75,000	50,000
Inventory	100,000	60,000
Land	175,000	40,000
Buildings & Equipment	800,000	600,000
Accumulated Depreciation	(400,000)	(300,000)
Investment in Special Foods Stock	300,000	
Total Assets	$1,100,000	$500,000
Liabilities & Stockholders' Equity		
Accounts Payable	$ 100,000	$100,000
Bonds Payable	200,000	100,000
Common Stock	500,000	200,000
Retained Earnings	300,000	100,000
Total Liabilities & Equity	$1,100,000	$500,000

FIGURE 2–6 Worksheet for Consolidated Balance Sheet, January 1, 20X1, Date of Combination; 100 Percent Acquisition at Book Value

	Peerless Products	Special Foods	Elimination Entries DR	Elimination Entries CR	Consolidated
Balance Sheet					
Cash	$ 50,000	$ 50,000			$ 100,000
Accounts Receivable	75,000	50,000			125,000
Inventory	100,000	60,000			160,000
Investment in Special Foods	300,000			$300,000	0
Land	175,000	40,000			215,000
Buildings & Equipment	800,000	600,000		300,000	1,100,000
Less: Accumulated Depreciation	(400,000)	(300,000)	300,000		(400,000)
Total Assets	**$1,100,000**	**$500,000**	**$300,000**	**$600,000**	**$1,300,000**
Accounts Payable	100,000	100,000			200,000
Bonds Payable	200,000	100,000			300,000
Common Stock	500,000	200,000	200,000		500,000
Retained Earnings	300,000	100,000	100,000		300,000
Total Liabilities & Equity	**$1,100,000**	**$500,000**	**$300,000**	**$ 0**	**$1,300,000**

Special Foods' net assets, and the book value of Special Foods' net assets can be illustrated as follows:



The book value of Special Foods' equity as of the acquisition date is equal to the sum of common stock and retained earnings:

Book Value Calculations:

	Total Investment	=	Common Stock	+	Retained Earnings
Original book value	300,000		200,000		100,000

Therefore, the elimination entry simply credits the Investment in Special Foods Stock account (for the acquisition price, $300,000) from Peerless' balance sheet. In this and all future examples, we use blue lettering to highlight the numbers from the book value analysis that appear in the basic elimination entry:

	Investment in Special Foods (Dr)	Investment in Special Foods (Cr)	
Acquisition Price	300,000		
		300,000	**Basic elimination entry**
	0		

The corresponding debits eliminate the beginning balances in the equity accounts of Special Foods:

Basic Elimination Entry:

Common stock	**200,000**		← Common stock balance
Retained earnings	**100,000**		← Beginning balance in ret. earnings
Investment in Special Foods		**300,000**	← Book value in investment account

Remember that this entry is made in the consolidation worksheet, not on the books of either the parent or the subsidiary, and is presented here in general journal form only for instructional purposes.

The investment account must be eliminated because, from a single entity viewpoint, a company cannot hold an investment in itself. The subsidiary's stock and the related stockholders' equity accounts must be eliminated because the subsidiary's stock is held entirely within the consolidated entity and none represents claims by outsiders.

From a somewhat different viewpoint, the investment account on the parent's books can be thought of as a single account representing the parent's investment in the net assets of the subsidiary, a so-called *one-line consolidation.* In a full consolidation, the subsidiary's individual assets and liabilities are combined with those of the parent. Including both the net assets of the subsidiary, as represented by the balance in the investment account, and the subsidiary's individual assets and liabilities would double-count the same set of assets. Therefore, the investment account is eliminated and not carried to the consolidated balance sheet.

In this example, the acquisition price of the stock acquired by Peerless is equal to the fair value of Special Foods as a whole. This reflects the normal situation in which the acquisition price paid by the parent is equal to the fair value of its proportionate share of the subsidiary. In addition, this example assumes that the subsidiary's fair value is equal to its book value, a generally unrealistic assumption. Given this assumption, however, the balance of Peerless' investment account is equal to Special Foods' stockholders' equity accounts, so this worksheet entry fully eliminates Peerless' investment account against Special Foods' stockholders' equity accounts.

The Optional Accumulation Elimination Entry

We now introduce a second elimination entry that is optional but that provides for a more "correct" consolidation. When the parent company acquires the subsidiary, the consolidated financial statements should appear as if all of the subsidiary's assets and liabilities were acquired at fair value as of the acquisition date. For example, if the acquisition were to be exercised as an acquisition of the assets instead of the stock of the company, the acquiring company would record each individual asset with a new basis equal to its fair value (and zero accumulated depreciation) on that date. The old book value and accumulated depreciation numbers from the seller would be disregarded. In the same way, when a company's stock is acquired in an acquisition, the consolidated financial statements should appear with all assets and liabilities recorded at their current fair market values. Thus, eliminating the old accumulated depreciation of the subsidiary as of the acquisition date and netting it out against the historical cost gives the appearance that the depreciable assets have been newly recorded at their fair value as of the acquisition date. In this example, the fair value of Special Foods' buildings and equipment is equal to their current book values. Special Foods' books indicate accumulated depreciation on the acquisition date of $300,000. Thus, the following elimination entry nets this accumulated depreciation against the cost of the building and equipment (which is equal to the fair value of these assets).

As explained previously, we repeat the accumulated depreciation entry in each succeeding period for as long as the subsidiary owns these assets. The purpose of this entry is to appropriately present these assets in the consolidated financial statements as if they had been purchased on the date the subsidiary was acquired at their acquisition date fair values.

Optional Accumulated Depreciation Elimination Entry:

Accumulated depreciation	**300,000**	
Building & equipment		**300,000**

← Accumulated depreciation at the time of the acquisition netted against cost

Note that this worksheet elimination entry does not change the net buildings and equipment balance. Netting the preacquisition accumulated depreciation against the cost basis of the corresponding assets merely causes the buildings and equipment to appear in the consolidated financial statements as if they had been revalued to their fair values on the acquisition date. This same entry would be included in each succeeding consolidation as long as the assets remain on Special Foods' books (always based on the acquisition date accumulated depreciation balance).

Consolidation Worksheet

We present the worksheet for the preparation of a consolidated balance sheet immediately following the acquisition in Figure 2–6. The first two columns of the worksheet in Figure 2–6 are the account balances taken from the books of Peerless and Special Foods, as shown in Figure 2–5. The balances of like accounts are placed side by side so that they may be added together. If more than two companies were to be consolidated, a separate column would be included in the worksheet for each additional subsidiary.

The accounts are placed in the worksheet in the order they would normally appear in the companies' financial statements. The two columns labeled *Elimination Entries* in Figure 2–6 are used to adjust the amounts reported by the individual companies to the amounts appropriate for the consolidated statement. All eliminations made in the worksheets are made in double-entry form. Thus, when the worksheet is completed, total debits entered in the Debit Eliminations column must equal total credits entered in the Credit Eliminations column. We highlight all parts of each elimination entry with the same color so that the reader can identify the individual elimination entries in the worksheet. After the appropriate elimination entries have been entered in the Elimination Entries columns, summing algebraically across the individual accounts provides the consolidated totals.

The consolidated balance sheet presented in Figure 2–7 comes directly from the last column of the consolidation worksheet in Figure 2–6. Because no operations occurred between the date of combination and the preparation of the consolidated balance sheet, the stockholders' equity section of the consolidated balance sheet is identical to that of Peerless in Figure 2–5.

FIGURE 2–7 Consolidated Balance Sheet, January 1, 20X1, Date of Combination; 100 Percent Acquisition at Book Value

PEERLESS PRODUCTS CORPORATION AND SUBSIDIARY
Consolidated Balance Sheet
January 1, 20X1

Assets			**Liabilities**	
Cash		$ 100,000	Accounts Payable	$ 200,000
Accounts Receivable		125,000	Bonds Payable	300,000
Inventory		160,000		
Land		215,000	Stockholders' Equity	
Buildings & Equipment	$1,100,000		Common Stock	500,000
Accumulated Depreciation	(400,000)	700,000	Retained Earnings	300,000
Total Assets		$1,300,000	Total Liabilities & Equity	$1,300,000

CONSOLIDATION SUBSEQUENT TO ACQUISITION

The preceding section introduced the procedures used to prepare a consolidated balance sheet as of the acquisition date. However, more than a consolidated balance sheet is needed to provide a comprehensive picture of the consolidated entity's activities following acquisition. As with a single company, the set of basic financial statements for a consolidated entity consists of a balance sheet, an income statement, a statement of changes in retained earnings, and a statement of cash flows.

This section of the chapter presents the procedures used to prepare an income statement, statement of retained earnings, and consolidated balance sheet subsequent to the acquisition date. We discuss the preparation of a consolidated statement of cash flows in Chapter 10.

The discussion that follows first deals with the important concepts of consolidated net income and consolidated retained earnings, followed by a description of the worksheet format used to facilitate the preparation of a full set of consolidated financial statements. We then discuss the specific procedures used to prepare consolidated financial statements subsequent to the date of combination.

This and subsequent chapters focus on procedures for consolidation when the parent company accounts for its investment in subsidiary stock using the equity method. If the parent accounts for its investment using the cost method, the general approach to the preparation of consolidated financial statements is the same, but the specific elimination entries differ. Appendix 2B summarizes consolidation procedures using the cost method. Regardless of the method the parent uses to account for its subsidiary investment, the consolidated statements will be the same because the investment and related accounts are eliminated in the consolidation process.

The approach followed to prepare a complete set of consolidated financial statements subsequent to a business combination is quite similar to that used to prepare a consolidated balance sheet as of the date of combination. However, in addition to the assets and liabilities, the consolidating companies' revenues and expenses must be combined. As the accounts are combined, eliminations must be made in the consolidation worksheet so that the consolidated financial statements appear as if they are the financial statements of a single company.

When a full set of consolidated financial statements is prepared subsequent to the date of combination, two of the important concepts affecting the statements are those of consolidated net income and consolidated retained earnings.

Consolidated Net Income

All revenues and expenses of the individual consolidating companies arising from transactions with unaffiliated companies are included in the consolidated financial statements. The consolidated income statement includes 100 percent of the revenues and expenses regardless of the parent's percentage ownership. Similar to single-company financial statements, where the difference between revenues and expenses equals net income, revenues minus expenses in the consolidated financial statements equal consolidated net income. ***Consolidated net income*** is equal to the parent's income from its own operations, excluding any investment income from consolidated subsidiaries, plus the net income from each of the consolidated subsidiaries, adjusted for any differential write-off (which is zero in this chapter). Intercorporate investment income from consolidated subsidiaries included in the parent's net income under either the cost or equity method must be eliminated in computing consolidated net income to avoid double-counting.

Consolidated net income and consolidated net income attributable to the controlling interest are the same when all consolidated subsidiaries are wholly owned. For example, assume that Push Corporation purchases all of the stock of Shove Company at an amount equal to its book value. During 20X1, Shove reports net income of $25,000 while Push reports net income of $125,000, including equity-method income from Shove of $25,000. Consolidated net income for 20X1 is computed as follows:

Push's net income	$125,000
Less: Equity-method income from Shove	(25,000)
Shove's net income	25,000
Consolidated net income	$125,000

Note that when the parent company properly applies the equity method, consolidated net income is always equal to the parent's equity-method net income.

Consolidated Retained Earnings

Consolidated retained earnings, as it appears in the consolidated balance sheet, is that portion of the consolidated enterprise's undistributed earnings accruing to the parent company shareholders. Consolidated retained earnings at the end of the period is equal to the beginning consolidated retained earnings balance, plus consolidated net income attributable to the controlling interest, less dividends declared by the parent company.

Computing Consolidated Retained Earnings

Consolidated retained earnings is computed by adding together the parent's retained earnings from its own operations (excluding any income from consolidated subsidiaries recognized by the parent) and the parent's proportionate share of the net income of each subsidiary since the date of acquisition, adjusted for differential write-off and goodwill impairment. Consolidated retained earnings should be equal to the parent's equity-method retained earnings.

If the parent accounts for subsidiaries using the equity method on its books, the retained earnings of each subsidiary is completely eliminated when the subsidiary is consolidated. This is necessary because (1) retained earnings cannot be purchased, and so subsidiary retained earnings at the date of a business combination cannot be included in the combined company's retained earnings; (2) the parent's share of the subsidiary's income since acquisition is already included in the parent's equity-method retained earnings; and (3) the noncontrolling interest's share (if any) of the subsidiary's retained earnings is not included in consolidated retained earnings.

In the simple example given previously, assume that on the date of combination, January 1, 20X1, Push's retained earnings balance is $400,000 and Shove's is $250,000. During 20X1, Shove reports $25,000 of net income and declares $10,000 of dividends. Push reports $100,000 of separate operating earnings plus $25,000 of equity-method income from its 100 percent interest in Shove; Push declares dividends of $30,000. Based on this information, the retained earnings balances for Push and Shove on December 31, 20X1, are computed as follows:

	Push	Shove
Balance, January 1, 20X1	$400,000	$250,000
Net income, 20X1	125,000	25,000
Dividends declared in 20X1	(30,000)	(10,000)
Balance, December 31, 20X1	$495,000	$265,000

Consolidated retained earnings is computed by first determining the parent's retained earnings from its own operations. This computation involves removing from the parent's retained earnings the $25,000 of subsidiary income since acquisition recognized by the parent, leaving $470,000 ($495,000 − $25,000) of retained earnings resulting from the parent's own operations. The parent's 100 percent share of the subsidiary's net income since the date of acquisition is then added to this number, resulting in consolidated retained earnings of $495,000. We note that because this is the first year since the acquisition, the net income since the date of acquisition is just this year's income. Subsequent examples will illustrate how this calculation differs in later years. We also emphasize that since Push uses the ***fully adjusted equity method,*** this number is the same as the parent's equity-method retained earnings.

CONSOLIDATED FINANCIAL STATEMENTS—100 PERCENT OWNERSHIP, CREATED OR ACQUIRED AT BOOK VALUE

Each of the consolidated financial statements is prepared as if it is taken from a single set of books that is being used to account for the overall consolidated entity. There is, of course, no set of books for the consolidated entity, and as in the preparation of the consolidated balance sheet, the consolidation process starts with the data recorded on the books of the individual consolidating companies. The account balances from the books of the individual companies are placed in the three-part worksheet, and entries are made to eliminate the effects of intercorporate ownership and transactions. The consolidation approach and procedures are the same whether the subsidiary being consolidated was acquired or created.

To understand the process of consolidation subsequent to the start of a parent–subsidiary relationship, assume that on January 1, 20X1, Peerless Products Corporation acquires all of the common stock of Special Foods Inc. for $300,000, an amount equal to Special Foods' book value on that date. At that time, Special Foods has $200,000 of common stock outstanding and retained earnings of $100,000, summarized as follows:

P	Fair value of consideration		$300,000
1/1/X1 100%	Book value of shares acquired		
	Common stock—Special Foods	$200,000	
	Retained earnings—Special Foods	100,000	
S			300,000
	Difference between fair value and book value		$ 0

Peerless accounts for its investment in Special Foods stock using the equity method. Information about Peerless and Special Foods as of the date of combination and for the years 20X1 and 20X2 appears in Figure 2–8.

FIGURE 2–8
Selected Information about Peerless Products and Special Foods on January 1, 20X1, and for the Years 20X1 and 20X2

	Peerless Products	Special Foods
Common Stock, January 1, 20X1	$500,000	$200,000
Retained Earnings, January 1, 20X1	300,000	100,000
20X1:		
Separate Operating Income, Peerless	140,000	
Net Income, Special Foods		50,000
Dividends	60,000	30,000
20X2:		
Separate Operating Income, Peerless	160,000	
Net Income, Special Foods		75,000
Dividends	60,000	40,000

Initial Year of Ownership

On January 1, 20X1, Peerless records its purchase of Special Foods common stock with the following entry:

(12)	Investment in Special Foods	300,000	
	Cash		300,000
	Record the purchase of Special Foods stock.		

During 20X1, Peerless records operating earnings of $140,000, excluding its income from investing in Special Foods, and declares dividends of $60,000. Special Foods reports 20X1 net income of $50,000 and declares dividends of $30,000.

Parent Company Entries

Peerless records its 20X1 income and dividends from Special Foods under the equity method as follows:

(13)	Investment in Special Foods	50,000	
	Income from Special Foods		50,000
	Record Peerless' 100% share of Special Foods' 20X1 income.		

(14)	Cash	30,000	
	Investment in Special Foods		30,000
	Record Peerless' 100% share of Special Foods' 20X1 dividend.		

Consolidation Worksheet—Initial Year of Ownership

After all appropriate entries have been made on the books of Peerless and Special Foods, including year-end adjustments, a consolidation worksheet is prepared as in Figure 2–9. The adjusted account balances from the books of Peerless and Special Foods are placed in the first two columns of the worksheet. Then all amounts that reflect intercorporate transactions or ownership are eliminated in the consolidation process.

The distinction between journal entries recorded on the books of the individual companies and the elimination entries recorded only on the consolidation worksheet is an important one. Book entries affect balances on the books and the amounts that are carried to the consolidation worksheet; worksheet elimination entries affect only those balances carried to the consolidated financial statements in the period. As mentioned previously, the elimination entries presented in this text are shaded both when presented in journal entry form in the text and in the worksheet.

In this example, the accounts that must be eliminated because of intercorporate ownership are the stockholders' equity accounts of Special Foods, including dividends declared, Peerless' investment in Special Foods stock, and Peerless' income from Special Foods. However, unlike previous examples, the book value portion of Peerless' investment has changed because earnings and dividends have adjusted the investment account balance. The book value portion of the investment account can be summarized as follows:

Book Value Calculations:

	Total Investment	=	Common Stock	+	Retained Earnings
Original book value	**300,000**		**200,000**		**100,000**
+ Net income	**50,000**				**50,000**
− Dividends	**(30,000)**				**(30,000)**
Ending book value	**320,000**		**200,000**		**120,000**

Under the equity method, Peerless recognizes its share (100 percent) of Special Foods' reported income. In the consolidated income statement, however, Special Foods' individual revenue and expense accounts are combined with Peerless' accounts. Peerless' equity method income from Special Foods, therefore, must be eliminated to avoid double-counting. Special Foods' dividends paid to Peerless must be eliminated when consolidated statements are prepared (because the dividend is really just an intercompany cash transfer, not a transfer of wealth to external shareholders) so that only dividend declarations related to the parent's shareholders are reported as dividends of the consolidated entity. Thus, the basic elimination entry removes both the equity method Income from Special Foods and also all dividends declared by Special Foods during the period:

Basic Elimination Entry:

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

The book value calculations in the chart on the previous page help to facilitate preparation of the basic elimination entry. Thus, the basic elimination entry removes (1) Special Foods' equity accounts, (2) Special Foods' dividends declared, (3) Peerless' Income from Special Foods account, and (4) Peerless' Investment in Special Foods account. Note that we use blue shading in the numbers in the book value analysis that appear in the basic elimination entry. Because there is no differential in this example, the basic elimination entry completely eliminates the balance in Peerless' investment account on the balance sheet as well as the Income from Special Foods account on the income statement in the worksheet. Additional elimination entries will be necessary when there is a differential as illustrated in Chapters 4 and 5.

	Investment in Special Foods			Income from Special Foods		
Acquisition Price	300,000					
Net Income	50,000				50,000	**Net Income**
		30,000	**Dividends**			
Ending Balance	320,000				50,000	**Ending Balance**
		320,000	**Basic**	50,000		
	0				0	

Worksheet Relationships

Both of the elimination entries are entered in Figure 2–9 and the amounts are totaled across each row and down each column to complete the worksheet. Some specific points to recognize with respect to the full worksheet are as follows:

1. Because of the normal articulation among the financial statements, the bottom-line number from each of the first two sections of the worksheet carries down to the next financial statement in a logical progression. As part of the normal accounting cycle, net income is closed to retained earnings, and retained earnings is reflected in the balance sheet. Therefore, in the consolidation worksheet, the net income is carried down to the retained earnings statement section of the worksheet, and the ending retained earnings line is carried down to the balance sheet section of the worksheet. Note that in both cases the entire line, including total eliminations, is carried forward.
2. Double-entry bookkeeping requires total debits to equal total credits for any single elimination entry and for the worksheet as a whole. Because some elimination entries extend to more than one section of the worksheet, however, the totals of the debit and credit eliminations are not likely to be equal in either of the first two sections of the worksheet. The totals of all debits and credits at the bottom of the balance sheet section are equal because the cumulative balances from the two upper sections are carried forward to the balance sheet section.

FIGURE 2–9 **December 31, 20X1, Equity-Method Worksheet for Consolidated Financial Statements, Initial Year of Ownership; 100 Percent Acquisition at Book Value**

	Peerless Products	Special Foods	Elimination Entries DR	Elimination Entries CR	Consolidated
Income Statement					
Sales	400,000	200,000			600,000
Less: Cost of Goods Sold (COGS)	(170,000)	(115,000)			(285,000)
Less: Depreciation Expense	(50,000)	(20,000)			(70,000)
Less: Other Expenses	(40,000)	(15,000)			(55,000)
Income from Special Foods	50,000		50,000		0
Net Income	**190,000**	**50,000**	**50,000**	**0**	**190,000**
Statement of Retained Earnings					
Beginning Balance	300,000	100,000	100,000		300,000
Net Income	**190,000**	**50,000**	**50,000**	**0**	190,000
Less: Dividends Declared	(60,000)	(30,000)		30,000	(60,000)
Ending Balance	**430,000**	**120,000**	**150,000**	**30,000**	**430,000**
Balance Sheet					
Cash	210,000	75,000			285,000
Accounts Receivable	75,000	50,000			125,000
Inventory	100,000	75,000			175,000
Investment in Special Foods	320,000			320,000	0
Land	175,000	40,000			215,000
Buildings & Equipment	800,000	600,000		300,000	1,100,000
Less: Accumulated Depreciation	(450,000)	(320,000)	300,000		(470,000)
Total Assets	**1,230,000**	**520,000**	**300,000**	**620,000**	**1,430,000**
Accounts Payable	100,000	100,000			200,000
Bonds Payable	200,000	100,000			300,000
Common Stock	500,000	200,000	200,000		500,000
Retained Earnings	**430,000**	**120,000**	**150,000**	**30,000**	430,000
Total Liabilities & Equity	**1,230,000**	**520,000**	**350,000**	**30,000**	**1,430,000**

3. In the balance sheet portion of the worksheet, total debit balances must equal total credit balances for each company and the consolidated entity.
4. When the parent uses the full equity method of accounting for the investment, consolidated net income should equal the parent's net income, and consolidated retained earnings should equal the parent's retained earnings. This means the existing balance in subsidiary retained earnings must be eliminated to avoid double-counting.
5. Certain other clerical safeguards are incorporated into the worksheet. The amounts reflected in the bottom line of the income statement section, when summed (algebraically) across, must equal the number reported as consolidated net income. Similarly, the amounts in the last line of the retained earnings statement section must equal consolidated retained earnings when summed across.

Second and Subsequent Years of Ownership

The consolidation procedures employed at the end of the second and subsequent years are basically the same as those used at the end of the first year. Adjusted trial balance data of the individual companies are used as the starting point each time consolidated statements are prepared because no separate books are kept for the consolidated entity. An additional check is needed in each period following acquisition to ensure that the beginning balance of consolidated retained earnings shown in the completed worksheet after elimination entries equals the balance reported at the end of the prior period. In all other respects, the elimination entries and worksheet are comparable with those shown for the first year.

Parent Company Entries

We illustrate consolidation after two years of ownership by continuing the example of Peerless Products and Special Foods, based on the data in Figure 2–8. Peerless' separate income from its own operations for 20X2 is $160,000, and its dividends total $60,000. Special Foods reports net income of $75,000 in 20X2 and pays dividends of $40,000. Peerless records the following equity-method entries in 20X2:

(15)	Investment in Special Foods	75,000	
	Income from Special Foods		75,000
	Record Peerless' 100% share of Special Foods' 20X2 income.		

(16)	Cash	40,000	
	Investment in Special Foods		40,000
	Record Peerless' 100% share of Special Foods' 20X2 dividend.		

The balance in the investment account reported by Peerless increases from $320,000 on January 1, 20X2, to $355,000 on December 31, 20X2, and reported net income of Peerless totals $235,000 ($160,000 + $75,000).

Consolidation Worksheet—Second Year of Ownership

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Figure 2–10 on page 76 illustrates the worksheet to prepare consolidated statements for 20X2. The book value of Peerless' investment in Special Foods (which is equal to the book value of Special Foods' equity accounts) can be analyzed and summarized as follows:

Book Value Calculations:

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

Again, the basic elimination entry removes (1) Special Foods' equity accounts, (2) Special Foods' dividends declared, (3) Peerless' Income from Special Foods account, and (4) Peerless' Investment in Special Foods account:

Basic Elimination Entry:

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

Note that the beginning balance in retained earnings in 20X2, $75,000, is different than the balance in 20X1 because of income earned and dividends declared during 20X1. As explained previously, since there is no differential in this example, the basic elimination entry completely eliminates the balance in Peerless' investment account on the balance sheet as well as the Income from Special Foods account on the income statement in the worksheet.

	Investment in Special Foods			Income from Special Foods		
Beginning Balance	**320,000**					
Net Income	**75,000**				**75,000**	**Net Income**
		40,000	**Dividends**			
Ending Balance	**355,000**				**75,000**	**Ending Balance**
		355,000	**Basic**	**75,000**		
	0				**0**	

In this example, Special Foods had accumulated depreciation of $300,000 on the acquisition date. Thus, we repeat the same accumulated depreciation elimination entry this year (and every year as long as Special Foods owns the assets) that we used in the initial year.

Optional Accumulated Depreciation Elimination Entry:

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

After placing the two elimination entries in the consolidation worksheet, it is completed in the normal manner as illustrated in Figure 2–10. All worksheet relationships discussed in conjunction with Figure 2–9 continue in the second year as well. The beginning

FIGURE 2–10 December 31, 20X2, Equity-Method Worksheet for Consolidated Financial Statements, Second Year of Ownership; 100 Percent Acquisition at Book Value

	Peerless Products	Special Foods	Elimination Entries DR	Elimination Entries CR	Consolidated
Income Statement					
Sales	450,000	300,000			750,000
Less: COGS	(180,000)	(160,000)			(340,000)
Less: Depreciation Expense	(50,000)	(20,000)			(70,000)
Less: Other Expenses	(60,000)	(45,000)			(105,000)
Income from Special Foods	75,000		75,000		0
Net Income	**235,000**	**75,000**	**75,000**	**0**	**235,000**
Statement of Retained Earnings					
Beginning Balance	430,000	120,000	120,000		430,000
Net Income	**235,000**	**75,000**	**75,000**	**0**	235,000
Less: Dividends Declared	(60,000)	(40,000)		40,000	(60,000)
Ending Balance	**605,000**	**155,000**	**195,000**	**40,000**	**605,000**
Balance Sheet					
Cash	245,000	85,000			330,000
Accounts Receivable	150,000	80,000			230,000
Inventory	180,000	90,000			270,000
Investment in Special Foods	355,000			355,000	0
Land	175,000	40,000			215,000
Buildings & Equipment	800,000	600,000		300,000	1,100,000
Less: Accumulated Depreciation	(500,000)	(340,000)	300,000		(540,000)
Total Assets	**1,405,000**	**555,000**	**300,000**	**655,000**	**1,605,000**
Accounts Payable	100,000	100,000			200,000
Bonds Payable	200,000	100,000			300,000
Common Stock	500,000	200,000	200,000		500,000
Retained Earnings	**605,000**	**155,000**	**195,000**	**40,000**	605,000
Total Liabilities & Equity	**1,405,000**	**555,000**	**395,000**	**40,000**	**1,605,000**

consolidated retained earnings balance for 20X2, as shown in Figure 2–10, should be compared with the ending consolidated retained earnings balance for 20X1, as shown in Figure 2–9, to ensure that they are the same.

Consolidated Net Income and Retained Earnings

In the consolidation worksheets illustrated in Figures 2–9 and 2–10, consolidated net income for 20X1 and 20X2 appear as the last numbers in the income statement section of the worksheets in the Consolidated column on the far right. The numbers can be computed as follows:

	20X1	20X2
Peerless' net income	$190,000	$235,000
Peerless' equity income from Special Foods	(50,000)	(75,000)
Special Foods' net income	50,000	75,000
Consolidated net income	$190,000	$235,000

In this simple illustration, consolidated net income is the same as Peerless' equity-method net income.

In Figures 2–9 and 2–10, the ending consolidated retained earnings number is equal to the beginning balance of consolidated retained earnings plus consolidated net income, less dividends declared on the parent's common stock. It also can be computed as follows:

	20X1	20X2
Peerless' beginning retained earnings from its own operations	$300,000	$380,000
Peerless' income from its own operations	140,000	160,000
Peerless' income from Special Foods since acquisition (cumulative)	50,000	125,000
Peerless' dividends declared	(60,000)	(60,000)
Consolidated retained earnings	$430,000	$605,000

STOP & THINK

Note that Peerless' beginning retained earnings from its own operations in 20X2, $380,000, is calculated as the beginning balance for 20X1 plus Peerless' income from its own operations in 20X1, $140,000, minus its dividends declared in 20X1, $60,000.

As with income, consolidated retained earnings is the same as the parent's equity-method retained earnings if the parent company uses the equity method. We note that the second year of this calculation illustrates how cumulative income from Special Foods (since the acquisition date) can be used to calculate ending retained earnings.

Summary of Key Concepts

Companies owning investments in the common stock of other companies generally report those investments by consolidating them or reporting them using the cost method (adjusted to market, if appropriate) or equity method, depending on the circumstances. Consolidation generally is appropriate if one entity controls the investee, usually through majority ownership of the investee's voting stock. The equity method is required when an investor has sufficient stock ownership in an investee to significantly influence the operating and financial policies of the investee but owns less than a majority of the investee's stock. In the absence of other evidence, ownership of 20 percent or more of an investee's voting stock is viewed as giving the investor the ability to exercise significant influence over the investee. The cost method is used when consolidation and the equity method are not appropriate, usually when the investor is unable to exercise significant influence over the investee.

The cost method is similar to the approach used in accounting for other noncurrent assets. The investment is carried at its original cost to the investor. Consistent with the realization concept, income from the investment is recognized when distributed by the investee in the form of dividends.

The equity method is unique in that the carrying value of the investment is adjusted periodically to reflect the investor's changing equity in the underlying investee. Income from the investment is recognized by the investor under the equity method as the investee reports the income rather than when it is distributed.

Companies also have the choice of reporting nonconsolidated investments using the fair value option instead of the cost or equity method. Under the fair value option, the investment is remeasured to fair value at the end of each reporting period and the change in value recognized as an unrealized gain or loss in income.

Consolidated financial statements present the financial position and results of operations of two or more separate legal entities as if they were a single company. A consolidated balance sheet prepared on the date a parent acquires a subsidiary appears the same as if the acquired company had been merged into the parent.

A consolidation worksheet provides a means of efficiently developing the data needed to prepare consolidated financial statements. The worksheet includes a separate column for the trial balance data of each of the consolidating companies, a debit and a credit column for the elimination entries, and a column for the consolidated totals that appear in the consolidated financial statements. A three-part consolidation worksheet facilitates preparation of a consolidated income statement, retained earnings statement, and balance sheet, and it includes a section for each statement. Elimination entries are needed in the worksheet to remove the effects of intercompany ownership and intercompany transactions so the consolidated financial statements appear as if the separate companies are actually one.

Key Terms

Appendix 2A Additional Considerations Relating to the Equity Method

Determination of Significant Influence

The general rule established in **ASC 323-10-15** is that the equity method is appropriate when the investor, by virtue of its common stock interest in an investee, is able to exercise significant influence over the operating and financial policies of the investee. In the absence of other evidence, common stock ownership of 20 percent or more is viewed as indicating that the investor is able to exercise significant influence over the investee. However, the APB also stated a number of factors that could constitute other evidence of the ability to exercise significant influence:

1. Representation on board of directors.
2. Participation in policy making.
3. Material intercompany transactions.
4. Interchange of managerial personnel.
5. Technological dependency.
6. Size of investment in relation to concentration of other shareholdings.

Conversely, the FASB provides in **ASC 323-10-15-10** some examples of evidence where an investor is unable to exercise significant influence over an investee. These situations include legal or regulatory challenges to the investor's influence by the investee, agreement by the investor to give up important shareholder rights, concentration of majority ownership among a small group of owners who disregard the views of the investor, and unsuccessful attempts by the investor to obtain information from the investee or to obtain representation on the investee's board of directors.

Alternative Versions of the Equity Method of Accounting for Investments in Subsidiaries

Companies are free to adopt whatever procedures they wish in accounting for investments in controlled subsidiaries on their books. Because investments in consolidated subsidiaries are eliminated when consolidated statements are prepared, the consolidated statements are not affected by the procedures used to account for the investments on the parent's books.

In practice, companies follow three different approaches in accounting for their consolidated subsidiaries:

1. Cost method.
2. Fully adjusted equity method.
3. Modified version of the equity method.

Several modified versions of the equity method are found in practice, and all are usually referred to as the ***modified equity method.*** Some companies apply the equity method without making adjustments for unrealized intercompany profits and the amortization of the differential. Others adjust for the amortization of the differential but omit the adjustments for unrealized intercompany profits. While modified versions of the equity method are not acceptable for financial reporting purposes, they may provide some clerical savings for the parent if used on the books when consolidation of the subsidiary is required.

Unrealized Intercompany Profits

The equity method as applied under **ASC 323-10-45-1** often is referred to as a ***one-line consolidation*** because (*a*) the investor's income and stockholders' equity are the same as if the investee were consolidated and (*b*) all equity method adjustments are made through the investment and related income accounts, which are reported in only a single line in the balance sheet and a single line in the income statement.[8] The view currently taken in consolidation is that intercompany sales do not result in the realization of income until the intercompany profit is confirmed in some way, usually through a transaction with an unrelated third party. For example, if a parent company sells inventory to a subsidiary at a profit, that profit cannot be recognized in the consolidated financial statements until it is confirmed by resale of the inventory to an external party. Because profits from sales to related companies are viewed from a consolidated perspective as being unrealized until there is a resale to unrelated parties, such profits must be eliminated when preparing consolidated financial statements.

The consolidated financial statements are not the only ones affected, however, because **ASC 323-10-45-1** requires that the income of an investor that reports an investment using the equity method must be the same as if the investee were consolidated. Therefore, the investor's equity-method income from the investee must be adjusted for unconfirmed profits on intercompany sales as well. The term for the application of the equity method that includes the adjustment for unrealized profit on sales to affiliates is fully adjusted equity method.

Adjusting for Unrealized Intercompany Profits

An intercompany sale normally is recorded on the books of the selling affiliate in the same manner as any other sale, including the recognition of profit. In applying the equity method, any intercompany profit remaining unrealized at the end of the period must be deducted from the amount of income that otherwise would be reported.

Under the one-line consolidation approach, the income recognized from the investment and the carrying amount of the investment are reduced to remove the effects of the unrealized intercompany profits. In future periods when the intercompany profit actually is realized, the entry is reversed.

Unrealized Profit Adjustments Illustrated

To illustrate the adjustment for unrealized intercompany profits under the equity method, assume that Palit Corporation owns 40 percent of the common stock of Label Manufacturing. During 20X1, Palit sells inventory to Label for $10,000; the inventory originally cost Palit $7,000. Label resells one-third of the inventory to outsiders during 20X1 and retains the other two-thirds in its ending inventory. The amount of unrealized profit is computed as follows:

Total intercompany profit	$10,000 − $7,000 = $3,000
Unrealized portion	$3,000 × 2/3 = $2,000

Assuming that Label reports net income of $60,000 for 20X1 and declares no dividends, the following entries are recorded on Palit's books at the end of 20X1:

(17)	Investment in Label Manufacturing	24,000	
	Income from Label Manufacturing		24,000
	Record equity-method income: $60,000 × 0.40.		
(18)	Income from Label Manufacturing	2,000	
	Investment in Label Manufacturing		2,000
	Remove unrealized intercompany profit.		

[8] Although **ASC 323-10-45-1** established the requirement for an equity-method investor's income and stockholders' equity to be the same as if the investee were consolidated, the FASB's recent decision not to permit the write-off of equity-method goodwill may lead to differences in situations in which such goodwill has been impaired.

If all the remaining inventory is sold in 20X2, the following entry is made on Palit's books at the end of 20X2 to record the realization of the previously unrealized intercompany profit:

(19)			
	Investment in Label Manufacturing Stock	2,000	
	Income from Label Manufacturing		2,000
	Recognize realized intercompany profit.		

Additional Requirements of ASC 323-10

ASC 323-10, the main authoritative guidance on equity-method reporting, includes several additional requirements:

1. The investor's share of the investee's extraordinary items and prior-period adjustments should be reported as such by the investor, if material.
2. If an investor's share of investee losses exceeds the carrying amount of the investment, the equity method should be discontinued once the investment has been reduced to zero. No further losses are to be recognized by the investor unless the investor is committed to provide further financial support for the investee or unless the investee's imminent return to profitability appears assured. If, after the equity method has been suspended, the investee reports net income, the investor again should apply the equity method, but only after the investor's share of net income equals its share of losses not previously recognized.
3. Preferred dividends of the investee should be deducted from the investee's net income if declared or, whether declared or not, if the preferred stock is cumulative, before the investor computes its share of investee earnings.

ASC 323-10-50-3 includes a number of required financial statement disclosures. When using the equity method, the investor must disclose[9] the following:

1. The name and percentage ownership of each investee.
2. The investor's accounting policies with respect to its investments in common stock, including the reasons for any departures from the 20 percent criterion established by **ASC 323-10-15.**
3. The amount and accounting treatment of any differential.
4. The aggregate market value of each identified nonsubsidiary investment where a quoted market price is available.
5. Either separate statements for or summarized information as to assets, liabilities, and results of operations of corporate joint ventures of the investor, if material in the aggregate.

Investor's Share of Other Comprehensive Income

When an investor uses the equity method to account for its investment in another company, the investor's comprehensive income should include its proportionate share of each of the amounts reported as "Other Comprehensive Income" by the investee. For example, assume that Ajax Corporation purchases 40 percent of the common stock of Barclay Company on January 1, 20X1. For the year 20X1, Barclay reports net income of $80,000 and comprehensive income of $115,000, which includes other comprehensive income (in addition to net income) of $35,000. This other comprehensive income (OCI) reflects an unrealized $35,000 gain (net of tax) resulting from an increase in the fair value of an investment in stock classified as available-for-sale under the criteria established by **ASC 320-10-35-1**. In addition to recording the normal equity-method entries, Ajax recognizes its proportionate share of the unrealized gain on available-for-sale securities reported by Barclay during 20X1 with the following entry:

(20)			
	Investment in Barclay Stock	14,000	
	Unrealized Gain on Investee AFS Investments		14,000
	Recognize share of investee's unrealized gain on available-for-sale securities.		

[9] **ASC 825-10-45** requires most of the same disclosures for investments in common stock reported under the fair value option that otherwise would have been reported using the equity method.

Entry (20) has no effect on Ajax's net income for 20X1, but it does increase Ajax's other comprehensive income, and thus its total comprehensive income, by $14,000. Ajax will make a similar entry at the end of each period for its proportionate share of any increase or decrease in Barclay's accumulated unrealized holding gain on the available-for-sale securities.

Appendix 2B Consolidation and the Cost Method

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Not all parent companies use the equity method to account for their subsidiary investments that are to be consolidated. The choice of the cost or equity method has no effect on the consolidated financial statements. This is true because the balance in the parent's investment account, the parent's income from the subsidiary, and related items are eliminated in preparing the consolidated statements. Thus, the parent is free to use either the cost method or some version of the equity method on its separate books in accounting for investments in subsidiaries that are to be consolidated.

Because the cost method uses different parent company entries than the equity method, it also requires different elimination entries in preparing the consolidation worksheet. Keep in mind that the consolidated financial statements appear the same regardless of whether the parent uses the cost or the equity method on its separate books.

CONSOLIDATION—YEAR OF COMBINATION

To illustrate the preparation of consolidated financial statements when the parent company carries its subsidiary investment using the cost method, refer again to the Peerless Products and Special Foods example. Assume that Peerless purchases 100 percent of the common stock of Special Foods on January 1, 20X1, for $300,000. At that date, the book value of Special Foods as a whole is $300,000. All other data are the same as presented in Figures 2–4 and 2–5.

Parent Company Cost-Method Entries

When the parent company uses the cost method, Peerless records only two journal entries during 20X1 related to its investment in Special Foods. Entry (21) records Peerless' purchase of Special Foods stock; entry (22) recognizes dividend income based on the $30,000 ($30,000 × 100%) of dividends received during the period:

(21)	Investment in Special Foods	300,000	
	Cash		300,000

Record the initial investment in Special Foods.

(22)	Cash	30,000	
	Dividend Income		30,000

Record Peerless' 100% share of Special Foods' 20X1 dividend.

No entries are made on the parent's books with respect to Special Foods income in 20X1, as would be done under the equity method.

Consolidation Worksheet—Year of Combination

Figure 2–11 illustrates the worksheet to prepare consolidated financial statements for December 31, 20X1, using the cost method. The trial balance data for Peerless and Special Foods included in the worksheet in Figure 2–11 differ from those presented in Figure 2–9 only by the effects of using the cost method rather than the equity method on Peerless' books. Note that all of the amounts in the Consolidated column are the same as in Figure 2–9 because the method used by the parent to account for its subsidiary investment on its books has no effect on the consolidated financial statements.

When a company uses the cost method, the basic elimination entry can be divided into two parts. The first eliminates the investment account. The investment elimination entry eliminates the balances in the stockholders' equity accounts of Special Foods and the balance in Peerless' investment account as of the date of combination. This elimination entry is the same each year (assuming there is no impairment of the investment account) because it relates to the original acquisition price and the original balances in Special Foods' equity accounts.

FIGURE 2–11 **December 31, 20X1, Cost-Method Worksheet for Consolidated Financial Statements, Initial Year of Ownership; 100 Percent Acquisition at Book Value**

	Peerless Products	Special Foods	Elimination Entries DR	Elimination Entries CR	Consolidated
Income Statement					
Sales	400,000	200,000			600,000
Less: COGS	(170,000)	(115,000)			(285,000)
Less: Depreciation Expense	(50,000)	(20,000)			(70,000)
Less: Other Expenses	(40,000)	(15,000)			(55,000)
Dividend Income	30,000		30,000		0
Net Income	**170,000**	**50,000**	**30,000**	**0**	**190,000**
Statement of Retained Earnings					
Beginning Balance	300,000	100,000	100,000		300,000
Net Income	**170,000**	**50,000**	**30,000**	**0**	190,000
Less: Dividends Declared	(60,000)	(30,000)		30,000	(60,000)
Ending Balance	**410,000**	**120,000**	**130,000**	**30,000**	**430,000**
Balance Sheet					
Cash	210,000	75,000			285,000
Accounts Receivable	75,000	50,000			125,000
Inventory	100,000	75,000			175,000
Investment in Special Foods	300,000			300,000	0
Land	175,000	40,000			215,000
Buildings & Equipment	800,000	600,000		300,000	1,100,000
Less: Accumulated Depreciation	(450,000)	(320,000)	300,000		(470,000)
Total Assets	**1,210,000**	**520,000**	**300,000**	**600,000**	**1,430,000**
Accounts Payable	100,000	100,000			200,000
Bonds Payable	200,000	100,000			300,000
Common Stock	500,000	200,000	200,000		500,000
Retained Earnings	**410,000**	**120,000**	**130,000**	**30,000**	430,000
Total Liabilities & Equity	**1,210,000**	**520,000**	**330,000**	**30,000**	**1,430,000**

Investment Elimination Entry:

Common stock	200,000	
Retained earnings	100,000	
Investment in Special Foods		300,000

The dividend elimination entry eliminates the dividend income recorded by Peerless during the period along with Special Foods' dividend declaration related to the stockholdings of Peerless.

Dividend Elimination Entry:

Dividend income	30,000	
Dividends declared		30,000

Finally, the accumulated depreciation elimination entry is the same as under the equity method.

Optional Accumulated Depreciation Elimination Entry:

Accumulated depreciation	300,000	
Building and equipment		300,000

As mentioned previously, the amounts in the Consolidated column of the worksheet in Figure 2–11 are the same as those in Figure 2–9 because the method used on the parent's books to account for the subsidiary investment does not affect the consolidated financial statements.

CONSOLIDATION—SECOND YEAR OF OWNERSHIP

Consolidation differences between cost-method accounting and equity-method accounting tend to be more evident in the second year of ownership simply because the equity method entries change every year while the cost-method entries are generally the same (with the exception of recording the initial investment).

Parent Company Cost-Method Entry

Peerless only records a single entry on its books in 20X2 related to its investment in Special Foods:

(23)	Cash	40,000	
	Dividend Income		40,000

Record Peerless' 100% share of Special Foods' 20X2 dividend.

Consolidation Worksheet—Second Year Following Combination

The worksheet elimination entries are identical to those used in the first year except that the amount of dividends declared by Special Foods in the second year is $40,000 instead of $30,000.

Investment Elimination Entry:

Common stock	200,000	
Retained earnings	100,000	
Investment in Special Foods		300,000

Dividend Elimination Entry:

Dividend income	40,000	
Dividends declared		40,000

Optional Accumulated Depreciation Elimination Entry:

Accumulated depreciation	300,000	
Building and equipment		300,000

Under the cost method, Peerless has not recognized any portion of the undistributed earnings of Special Foods on its parent company books. Therefore, Peerless' retained earnings at the beginning of the second year are less than consolidated retained earnings. Also, Peerless' Investment in Special Foods account balance is less than its 100 percent share of Special Foods' net assets at that date. The consolidation worksheet in Figure 2–12 demonstrates how the worksheet entries eliminate the balances reported by Peerless under the cost method.

Note that while the Consolidated column yields identical numbers to those found in Figure 2–10, the cost method does not maintain the favorable properties that exist when the equity method is employed. Specifically, the parent's net income no longer equals consolidated net income, and the parent's retained earnings no longer equals consolidated retained earnings balance. Hence, although the procedures used under the cost method require less work, the parent company does not enjoy some of the favorable relationships among parent and consolidated numbers that exist under the equity method.

Questions

LO 2-1 **Q2-1** What types of investments in common stock normally are accounted for using *(a)* the equity method and *(b)* the cost method?

LO 2-1 **Q2-2A** How is the ability to significantly influence the operating and financial policies of a company normally demonstrated?

"A" and "B" indicate that the item relates to Appendix 2A and Appendix 2B, respectively.

FIGURE 2-12 **December 31, 20X1, Cost-Method Worksheet for Consolidated Financial Statements, Second Year of Ownership; 100 Percent Acquisition at Book Value**

	Peerless Products	Special Foods	Elimination Entries DR	Elimination Entries CR	Consolidated
Income Statement					
Sales	450,000	300,000			750,000
Less: COGS	(180,000)	(160,000)			(340,000)
Less: Depreciation Expense	(50,000)	(20,000)			(70,000)
Less: Other Expenses	(60,000)	(45,000)			(105,000)
Income from Special Foods	40,000		40,000		0
Net Income	**200,000**	**75,000**	**40,000**	**0**	**235,000**
Statement of Retained Earnings					
Beginning Balance	410,000	120,000	100,000		430,000
Net Income	**200,000**	**75,000**	**40,000**	**0**	235,000
Less: Dividends Declared	(60,000)	(40,000)		40,000	(60,000)
Ending Balance	**550,000**	**155,000**	**140,000**	**40,000**	**605,000**
Balance Sheet					
Cash	245,000	85,000			330,000
Accounts Receivable	150,000	80,000			230,000
Inventory	180,000	90,000			270,000
Investment in Special Foods	300,000			300,000	0
Land	175,000	40,000			215,000
Buildings & Equipment	800,000	600,000		300,000	1,100,000
Less: Accumulated Depreciation	(500,000)	(340,000)	300,000		(540,000)
Total Assets	**1,350,000**	**555,000**	**300,000**	**600,000**	**1,605,000**
Accounts Payable	100,000	100,000			200,000
Bonds Payable	200,000	100,000			300,000
Common Stock	500,000	200,000	200,000		500,000
Retained Earnings	**550,000**	**155,000**	**140,000**	**40,000**	605,000
Total Liabilities & Equity	**1,350,000**	**555,000**	**340,000**	**40,000**	**1,605,000**

LO 2-1 **Q2-3A** When is equity-method reporting considered inappropriate even though sufficient common shares are owned to allow the exercise of significant influence?

LO 2-4 **Q2-4** When will the balance in the intercorporate investment account be the same under the cost method and the equity method?

LO 2-2, 2-3 **Q2-5** Describe an investor's treatment of an investee's prior-period dividends and earnings when the investor acquires significant influence through a purchase of additional stock.

LO 2-2, 2-3 **Q2-6** From the point of view of an investor in common stock, what is a liquidating dividend?

LO 2-2, 2-3 **Q2-7** What effect does a liquidating dividend have on the balance in the investment account under the cost method and the equity method?

LO 2-2, 2-3 **Q2-8** How is the receipt of a dividend recorded under the equity method? Under the cost method?

LO 2-5 **Q2-9** How does the fair value method differ from the cost method and equity method in reporting income from nonsubsidiary investments?

LO 2-3 **Q2-10A** How does the fully adjusted equity method differ from the modified equity method?

LO 2-4 **Q2-11** Explain the concept of a one-line consolidation.

LO 2-3 **Q2-12A** What is the modified equity method? When might a company choose to use the modified equity method rather than the fully adjusted equity method?

LO 2-3 **Q2-13A** How are extraordinary items of the investee disclosed by the investor under equity-method reporting?

LO 2-7 **Q2-14** How does an elimination entry differ from an adjusting entry?

LO 2-6, 2-7 **Q2-15** What portion of the balances of subsidiary stockholders' equity accounts is included in the consolidated balance sheet?

LO 2-7 **Q2-16** How does the elimination process change when consolidated statements are prepared after—rather than at—the date of acquisition?

LO 2-7 **Q2-17** What are the three parts of the consolidation worksheet, and what sequence is used in completing the worksheet parts?

LO 2-7 **Q2-18** How are a subsidiary's dividend declarations reported in the consolidated retained earnings statement?

LO 2-7 **Q2-19** How is consolidated net income computed in a consolidation worksheet?

LO 2-7 **Q2-20** Give a definition of *consolidated retained earnings*.

LO 2-7 **Q2-21** How is the amount reported as consolidated retained earnings determined?

LO 2-7 **Q2-22** Why is the beginning retained earnings balance for each company entered in the three-part consolidation worksheet rather than just the ending balance?

Cases

LO 2-2, 2-3 **C2-1A** **Choice of Accounting Method**

Understanding

Slanted Building Supplies purchased 32 percent of the voting shares of Flat Flooring Company in March 20X3. On December 31, 20X3, the officers of Slanted Building Supplies indicated they needed advice on whether to use the equity method or cost method in reporting their ownership in Flat Flooring.

Required

a. What factors should be considered in determining whether equity-method reporting is appropriate?

b. Which of the two methods is likely to show the larger reported contribution to Slanted's earnings in 20X4? Explain.

c. Why might the use of the equity method become more appropriate as the percentage of ownership increases?

LO 2-2, 2-3 **C2-2** **Intercorporate Ownership**

Research

Most Company purchased 90 percent of the voting common stock of Port Company on January 1, 20X4, and 15 percent of the voting common stock of Adams Company on July 1, 20X4. In preparing the financial statements for Most Company at December 31, 20X4, you discover that Port Company purchased 10 percent of the common stock of Adams Company in 20X2 and continues to hold those shares. Adams Company reported net income of $200,000 for 20X4 and paid a dividend of $70,000 on December 20, 20X4.

Required

Most Company's chief accountant instructs you to review the Accounting Standards Codification and prepare a memo discussing whether the cost or equity method should be used in reporting the investment in Adams Company in Most's consolidated statements prepared at December 31, 20X4. Support your recommendations with citations and quotations from the authoritative financial reporting standards or other literature.

LO 2-2, 2-3 **C2-3A** **Application of the Equity Method**

Research

Forth Company owned 85,000 of Brown Company's 100,000 shares of common stock until January 1, 20X2, at which time it sold 70,000 of the shares to a group of seven investors, each of whom purchased 10,000 shares. On December 3, 20X2, Forth received a dividend of $9,000 from Brown. Forth continues to purchase a substantial portion of Brown's output under a contract that runs until the end of 20X9. Because of this arrangement, Forth is permitted to place two of its employees on Brown's board of directors.

Required

Forth Company's controller is not sure whether the company should use the cost or equity method in accounting for its investment in Brown Company. The controller asked you to review the relevant accounting literature and prepare a memo containing your recommendations. Support your recommendations with citations and quotations from the Accounting Standards Codification.

LO 2-6, 2-7

C2-4 Need for Consolidation Process

Communication

At a recent staff meeting, the vice president of marketing appeared confused. The controller had assured him that the parent company and each of the subsidiary companies had properly accounted for all transactions during the year. After several other questions, he finally asked, "If it has been done properly, then why must you spend so much time and make so many changes to the amounts reported by the individual companies when you prepare the consolidated financial statements each month? You should be able to just add the reported balances together."

Required

Prepare an appropriate response to help the controller answer the marketing vice president's question.

LO 2-1

C2-5 Account Presentation

Research

Prime Company has been expanding rapidly and is now an extremely diversified company for its size. It currently owns three companies with manufacturing facilities, two companies primarily in retail sales, a consumer finance company, and two natural gas pipeline companies. This has led to some conflict between the company's chief accountant and its treasurer. The treasurer advocates presenting no more than five assets and three liabilities on its balance sheet. The chief accountant has resisted combining balances from substantially different subsidiaries and has asked for your assistance.

Required

Research the Accounting Standards Codification to see what guidance is provided and prepare a memo to the chief accountant with your findings. Include citations to and quotations from the most relevant references. Include in your memo at least two examples of situations in which it may be inappropriate to combine similar-appearing accounts of two subsidiaries.

LO 2-6, 2-7

C2-6 Consolidating an Unprofitable Subsidiary

Research

Amazing Chemical Corporation's president had always wanted his own yacht and crew and concluded that Amazing Chemical should diversify its investments by purchasing an existing boatyard and repair facility on the lakeshore near his summer home. He could then purchase a yacht and have a convenient place to store it and have it repaired. Although the board of directors was never formally asked to approve this new venture, the president moved forward with optimism and a rather substantial amount of corporate money to purchase full ownership of the boatyard, which had lost rather significant amounts of money each of the five prior years and had never reported a profit for the original owners.

Not surprisingly, the boatyard continued to lose money after Amazing Chemical purchased it, and the losses grew larger each month. Amazing Chemical, a very profitable chemical company, reported net income of $780,000 in 20X2 and $850,000 in 20X3 even though the boatyard reported net losses of $160,000 in 20X2 and $210,000 in 20X3 and was fully consolidated.

Required

Amazing Chemical's chief accountant has become concerned that members of the board of directors or company shareholders will accuse him of improperly preparing the consolidated statements. The president does not plan to tell anyone about the losses, which do not show up in the consolidated income statement that the chief accountant prepared. You have been asked to prepare a memo to the chief accountant indicating the way to include subsidiaries in the consolidated income statement and to provide citations to or quotations from the Accounting Standards Codification that would assist the chief accountant in dealing with this matter. You have also been asked to search the accounting literature to see whether any reporting requirements require disclosure of the boatyard in notes to the financial statements or in management's discussion and analysis.

Exercises

LO 2-2, 2-3

E2-1 Multiple-Choice Questions on Use of Cost and Equity Methods [AICPA Adapted]

Select the correct answer for each of the following questions.

1. Peel Company received a cash dividend from a common stock investment. Should Peel report an **increase** in the investment account if it uses the cost method or equity method of accounting?

	Cost	Equity
a.	No	No
b.	Yes	Yes
c.	Yes	No
d.	No	Yes

2. In 20X0, Neil Company held the following investments in common stock:
   - 25,000 shares of B&K Inc.'s 100,000 outstanding shares. Neil's level of ownership gives it the ability to exercise significant influence over the financial and operating policies of B&K.
   - 6,000 shares of Amal Corporation's 309,000 outstanding shares.

   During 20X0, Neil received the following distributions from its common stock investments:

November 6	$30,000 cash dividend from B&K
November 11	$1,500 cash dividend from Amal
December 26	3 percent common stock dividend from Amal The closing price of this stock was $115 per share.

   What amount of dividend revenue should Neil report for 20X0?

   a. $1,500.
   b. $4,200.
   c. $31,500.
   d. $34,200.

3. An investor uses the equity method to account for an investment in common stock. Assume that (1) the investor owns more than 50 percent of the outstanding common stock of the investee, (2) the investee company reports net income and declares dividends during the year, and (3) the investee's net income is more than the dividends it declares. How would the investor's investment in the common stock of the investee company under the equity method differ at year-end from what it would have been if the investor had accounted for the investment under the cost method?

   a. The balance under the equity method is higher than it would have been under the cost method.
   b. The balance under the equity method is lower than it would have been under the cost method.
   c. The balance under the equity method is higher than it would have been under the cost method, but only if the investee company actually paid the dividends before year-end.
   d. The balance under the equity method is lower than it would have been under the cost method, but only if the investee company actually paid the dividends before year-end.

4. A corporation exercises significant influence over an affiliate in which it holds a 40 percent common stock interest. If its affiliate completed a fiscal year profitably but paid no dividends, how would this affect the investor corporation?

   a. Result in an increased current ratio.
   b. Result in increased earnings per share.
   c. Increase asset turnover ratios.
   d. Decrease book value per share.

5. An investor in common stock received dividends in excess of the investor's share of investee's earnings subsequent to the date of the investment. How will the investor's investment account be affected by those dividends under each of the following methods?

	Cost Method	Equity Method
a.	No effect	No effect
b.	Decrease	No effect
c.	No effect	Decrease
d.	Decrease	Decrease

6. An investor uses the cost method to account for an investment in common stock. A portion of the dividends received this year was in excess of the investor's share of the investee's earnings subsequent to the date of investment. The amount of dividend revenue that should be reported in the investor's income statement for this year would be
   a. Zero.
   b. The total amount of dividends received this year.
   c. The portion of the dividends received this year that was in excess of the investor's share of investee's earnings subsequent to the date of investment.
   d. The portion of the dividends received this year that was not in excess of the investor's share of the investee's earnings subsequent to the date of investment.

LO 2-4

E2-2 Multiple-Choice Questions on Intercorporate Investments

Select the correct answer for each of the following questions.

1. Companies often acquire ownership in other companies using a variety of ownership arrangements. The investor should use equity-method reporting whenever
   a. The investor purchases voting common stock of the investee.
   b. The investor has significant influence over the operating and financing decisions of the investee.
   c. The investor purchases goods and services from the investee.
   d. The carrying value of the investment is less than the market value of the investee's shares held by the investor.
2. The carrying amount of an investment in stock correctly accounted for under the equity method is equal to
   a. The original price paid to purchase the investment.
   b. The original price paid to purchase the investment plus cumulative net income plus cumulative dividends declared by the investee since the date the investment was acquired.
   c. The original price paid to purchase the investment plus cumulative net income minus cumulative dividends declared by the investee since the date the investment was acquired.
   d. The original price paid to purchase the investment minus cumulative net income minus cumulative dividends declared by the investee since the date the investment was acquired.

LO 2-3

E2-3 Multiple-Choice Questions on Applying Equity Method [AICPA Adapted]

Select the correct answer for each of the following questions.

1. On January 2, 20X3, Kean Company purchased a 30 percent interest in Pod Company for $250,000. Pod reported net income of $100,000 for 20X3 and declared and paid a dividend of $10,000. Kean accounts for this investment using the equity method. In its December 31, 20X3, balance sheet, what amount should Kean report as its investment in Pod?
   a. $160,000.
   b. $223,000.
   c. $340,000.
   d. $277,000.

2. On January 1, 20X8, Mega Corporation acquired 10 percent of the outstanding voting stock of Penny Inc. On January 2, 20X9, Mega gained the ability to exercise significant influence over Penny's financial and operating decisions by acquiring an additional 20 percent of Penny's outstanding stock. The two purchases were made at prices proportionate to the value assigned to Penny's net assets, which equaled their carrying amounts. For the years ended December 31, 20X8 and 20X9, Penny reported the following:

	20X8	20X9
Dividends Paid	$200,000	$300,000
Net Income	600,000	650,000

In 20X9, what amounts should Mega report as current year investment income and as an adjustment, before income taxes, to 20X8 investment income?

	20X9 Investment Income	Adjustment to 20X8 Investment Income
a.	$195,000	$160,000
b.	$195,000	$100,000
c.	$195,000	$ 40,000
d.	$105,000	$ 40,000

3. Investor Inc. owns 40 percent of Alimand Corporation. During the calendar year 20X5, Alimand had net earnings of $100,000 and paid dividends of $10,000. Investor mistakenly recorded these transactions using the cost method rather than the equity method of accounting. What effect would this have on the investment account, net earnings, and retained earnings, respectively?

   a. Understate, overstate, overstate.
   b. Overstate, understate, understate.
   c. Overstate, overstate, overstate.
   d. Understate, understate, understate.

4. A corporation using the equity method of accounting for its investment in a 40 percent–owned investee, which earned $20,000 and paid $5,000 in dividends, made the following entries:

Investment in Investee	8,000	
Income from Investee		8,000

Cash	2,000	
Dividend Revenue		2,000

What effect will these entries have on the investor's statement of financial position?

   a. Financial position will be fairly stated.
   b. Investment in the investee will be overstated, retained earnings understated.
   c. Investment in the investee will be understated, retained earnings understated.
   d. Investment in the investee will be overstated, retained earnings overstated.

LO 2-4

E2-4 Cost versus Equity Reporting

Winston Corporation purchased 40 percent of the stock of Fullbright Company on January 1, 20X2, at underlying book value. The companies reported the following operating results and dividend payments during the first three years of intercorporate ownership:

	Winston Corporation		Fullbright Company	
Year	**Operating Income**	**Dividends**	**Net Income**	**Dividends**
20X2	$100,000	$ 40,000	$70,000	$30,000
20X3	60,000	80,000	40,000	60,000
20X4	250,000	120,000	25,000	50,000

Required

Compute the net income reported by Winston for each of the three years, assuming it accounts for its investment in Fullbright using (*a*) the cost method and (*b*) the equity method.

LO 2-2, 2-3

E2-5 Acquisition Price

Phillips Company bought 40 percent ownership in Jones Bag Company on January 1, 20X1, at underlying book value. In 20X1, 20X2, and 20X3, Jones Bag reported the following:

Year	Net Income	Dividends
20X1	$ 8,000	$15,000
20X2	12,000	10,000
20X3	20,000	10,000

The balance in Phillips Company's investment account on December 31, 20X3, was $54,000.

Required

In each of the following independent cases, determine the amount that Phillips paid for its investment in Jones Bag stock assuming that Phillips accounted for its investment using the (*a*) cost method and (*b*) equity method.

LO 2-2, 2-3

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E2-6 Investment Income

Ravine Corporation purchased 30 percent ownership of Valley Industries for $90,000 on January 1, 20X6, when Valley had capital stock of $240,000 and retained earnings of $60,000. The following data were reported by the companies for the years 20X6 through 20X9:

			Dividends Declared	
Year	**Operating Income, Ravine Corporation**	**Net Income, Valley Industries**	**Ravine**	**Valley**
20X6	$140,000	$30,000	$ 70,000	$20,000
20X7	80,000	50,000	70,000	40,000
20X8	220,000	10,000	90,000	40,000
20X9	160,000	40,000	100,000	20,000

Required

a. What net income would Ravine Corporation have reported for each of the years, assuming Ravine accounts for the intercorporate investment using (1) the cost method and (2) the equity method?

b. Give all appropriate journal entries for 20X8 that Ravine made under both the cost and the equity methods.

LO 2-3

E2-7 Investment Value

Port Company purchased 30,000 of the 100,000 outstanding shares of Sund Company common stock on January 1, 20X2, for $180,000. The purchase price was equal to the book value of the shares purchased. Sund reported the following:

Year	Net Income	Dividends
20X2	$40,000	$25,000
20X3	30,000	
20X4	5,000	

Required

Compute the amounts Port Company should report as the carrying values of its investment in Sund Company at December 31, 20X2, 20X3, and 20X4.

LO 2-2, 2-3

E2-8A Income Reporting

Grandview Company purchased 40 percent of the stock of Spinet Corporation on January 1, 20X8, at underlying book value. Spinet recorded the following income for 20X9:

Income before Extraordinary Gain	$60,000
Extraordinary Gain	30,000
Net Income	$90,000

Required

Prepare all journal entries on Grandview's books for 20X9 to account for its investment in Spinet.

LO 2-4, 2-5

E2-9 Fair Value Method

Small Company reported 20X7 net income of $40,000 and paid dividends of $15,000 during the year. Mock Corporation acquired 20 percent of Small's shares on January 1, 20X7, for $105,000. At December 31, 20X7, Mock determined the fair value of the shares of Small to be $121,000. Mock reported operating income of $90,000 for 20X7.

Required

Compute Mock's net income for 20X7 assuming it uses

a. The cost method in accounting for its investment in Small.

b. The equity method in accounting for its investment in Small.

c. The fair value method in accounting for its investment in Small.

LO 2-3, 2-5

E2-10 Fair Value Recognition

Kent Company purchased 35 percent ownership of Lomm Company on January 1, 20X8, for $140,000. Lomm reported 20X8 net income of $80,000 and paid dividends of $20,000. At December 31, 20X8, Kent determined the fair value of its investment in Lomm to be $174,000.

Required

Give all journal entries recorded by Kent with respect to its investment in Lomm in 20X8 assuming it uses

a. The equity method.

b. The fair value method.

LO 2-3, 2-5

E2-11A Investee with Preferred Stock Outstanding

Reden Corporation purchased 45 percent of Montgomery Company's common stock on January 1, 20X9, at underlying book value of $288,000. Montgomery's balance sheet contained the following stockholders' equity balances:

Preferred Stock ($5 par value, 50,000 shares issued and outstanding)	$250,000
Common Stock ($1 par value, 150,000 shares issued and outstanding)	150,000
Additional Paid-In Capital	180,000
Retained Earnings	310,000
Total Stockholders' Equity	$890,000

Montgomery's preferred stock is cumulative and pays a 10 percent annual dividend. Montgomery reported net income of $95,000 for 20X9 and paid total dividends of $40,000.

Required

Give the journal entries recorded by Reden Corporation for 20X9 related to its investment in Montgomery Company common stock.

LO 2-2, 2-3

E2-12A Other Comprehensive Income Reported by Investee

Callas Corporation paid $380,000 to acquire 40 percent ownership of Thinbill Company on January 1, 20X9. The amount paid was equal to Thinbill's underlying book value. During 20X9, Thinbill reported operating income of $45,000 and an increase of $20,000 in the market value of available-for-sale securities held for the year. Thinbill paid dividends of $9,000 on December 10, 20X9.

Required

Give all journal entries that Callas Corporation recorded in 20X9, including closing entries at December 31, 20X9, associated with its investment in Thinbill Company.

LO 2-2, 2-3

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E2-13A Other Comprehensive Income Reported by Investee

Baldwin Corporation purchased 25 percent of Gwin Company's common stock on January 1, 20X8, at underlying book value. In 20X8, Gwin reported a net loss of $20,000 and paid dividends of $10,000, and in 20X9, The company reported net income of $68,000 and paid dividends of $16,000. Gwin also purchased marketable securities classified as available-for-sale on February 8, 20X9, and reported an increase of $12,000 in their fair value at December 31, 20X9. Baldwin reported a balance of $67,000 in its investment in Gwin at December 31, 20X9.

Required

Compute the amount paid by Baldwin Corporation to purchase the shares of Gwin Company.

LO 2-7

E2-14 Basic Elimination Entry

On December 31, 20X3, Broadway Corporation reported common stock outstanding of $200,000, additional paid-in capital of $300,000, and retained earnings of $100,000. On January 1, 20X4, Johe Company acquired control of Broadway in a business combination.

Required

Give the elimination entry that would be needed in preparing a consolidated balance sheet immediately following the combination if Johe acquired all of Broadway's outstanding common stock for $600,000.

LO 2-6, 2-7

E2-15 Balance Sheet Worksheet

Blank Corporation acquired 100 percent of Faith Corporation's common stock on December 31, 20X2, for $150,000. Data from the balance sheets of the two companies included the following amounts as of the date of acquisition:

Item	Blank Corporation	Faith Corporation
Cash	$ 65,000	$ 18,000
Accounts Receivable	87,000	37,000
Inventory	110,000	60,000
Buildings & Equipment (net)	220,000	150,000
Investment in Faith Corporation Stock	150,000	
Total Assets	$632,000	$265,000
Accounts Payable	$ 92,000	$ 35,000
Notes Payable	150,000	80,000
Common Stock	100,000	60,000
Retained Earnings	290,000	90,000
Total Liabilities & Stockholders' Equity	$632,000	$265,000

At the date of the business combination, the book values of Faith's net assets and liabilities approximated fair value. Assume that Faith Corporation's accumulated depreciation on buildings and equipment on the acquisition date was $30,000.

Required

a. Give the elimination entry or entries needed to prepare a consolidated balance sheet immediately following the business combination.

b. Prepare a consolidated balance sheet worksheet.

LO 2-3, 2-7

E2-16 Consolidation Entries for Wholly Owned Subsidiary

Trim Corporation acquired 100 percent of Round Corporation's voting common stock on January 1, 20X2, for $400,000. At that date, the book values and fair values of Round's assets and liabilities were equal. Round reported the following summarized balance sheet data:

Assets	$700,000	Accounts Payable	$100,000
		Bonds Payable	200,000
		Common Stock	120,000
		Retained Earnings	280,000
Total	$700,000	Total	$700,000

Round reported net income of $80,000 for 20X2 and paid dividends of $25,000.

Required

a. Give the journal entries recorded by Trim Corporation during 20X2 on its books if Trim accounts for its investment in Round using the equity method.

b. Give the elimination entries needed at December 31, 20X2, to prepare consolidated financial statements.

LO 2-3, 2-7

E2-17 Basic Consolidation Entries for Fully Owned Subsidiary

Amber Corporation reported the following summarized balance sheet data on December 31, 20X6:

Assets	$600,000	Liabilities	$100,000
		Common Stock	300,000
		Retained Earnings	200,000
Total	$600,000	Total	$600,000

On January 1, 20X7, Purple Company acquired 100 percent of Amber's stock for $500,000. At the acquisition date, the book values and fair values of Amber's assets and liabilities were equal. Amber reported net income of $50,000 for 20X7 and paid dividends of $20,000.

Required

a. Give the journal entries recorded by Purple on its books during 20X7 if it accounts for its investment in Amber using the equity method.

b. Give the elimination entries needed on December 31, 20X7, to prepare consolidated financial statements.

Problems

LO 2-2, 2-3

P2-18 Retroactive Recognition

Idle Corporation has been acquiring shares of Fast Track Enterprises at book value for the last several years. Fast Track provided data including the following:

	20X2	20X3	20X4	20X5
Net Income	$40,000	$60,000	$40,000	$50,000
Dividends	20,000	20,000	10,000	20,000

Fast Track declares and pays its annual dividend on November 15 each year. Its net book value on January 1, 20X2, was $250,000. Idle purchased shares of Fast Track on three occasions:

Date	Percent of Ownership Purchased	Amount Paid
January 1, 20X2	10%	$25,000
July 1, 20X3	5	15,000
January 1, 20X5	10	34,000

Required

Give the journal entries to be recorded on Idle's books in 20X5 related to its investment in Fast Track.

LO 2-4, 2-5

P2-19 Fair Value Method

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Gant Company purchased 20 percent of the outstanding shares of Temp Company for $70,000 on January 1, 20X6. The following results are reported for Temp Company:

	20X6	20X7	20X8
Net income	$40,000	$35,000	$60,000
Dividends paid	15,000	30,000	20,000
Fair value of shares held by Gant:			
January 1	70,000	89,000	86,000
December 31	89,000	86,000	97,000

Required

Determine the amounts reported by Gant as income from its investment in Temp for each year and the balance in Gant's investment in Temp at the end of each year assuming that Gant uses the following methods in accounting for its investment in Temp:

a. Cost method.

b. Equity method

c. Fair value method.

LO 2-5

P2-20 Fair Value Journal Entries

Marlow Company acquired 40 percent of the voting shares of Brown Company on January 1, 20X8, for $85,000. The following results are reported for Brown Company:

	20X8	20X9
Net income	$20,000	$30,000
Dividends paid	10,000	15,000
Fair value of shares held by Marlow:		
January 1	85,000	97,000
December 31	97,000	92,000

Required

Give all journal entries recorded by Marlow for 20X8 and 20X9 assuming that it uses the fair value method in accounting for its investment in Brown.

LO 2-5

P2-21A Other Comprehensive Income Reported by Investee

Dewey Corporation owns 30 percent of the common stock of Jimm Company, which it purchased at underlying book value on January 1, 20X5. Dewey reported a balance of $245,000 for its investment in Jimm Company on January 1, 20X5, and $276,800 at December 31, 20X5. During 20X5, Dewey and Jimm Company reported operating income of $340,000 and $70,000, respectively. Jimm received dividends from investments in marketable equity securities in the amount of $7,000 during 20X5. It also reported an increase of $18,000 in the market value of its portfolio of trading securities and an increase in the value of its portfolio of securities classified as available-for-sale. Jimm paid dividends of $20,000 in 20X5. Ignore income taxes in determining your solution.

Required

a. Assuming that Dewey uses the equity method in accounting for its investment in Jimm, compute the amount of income from Jimm recorded by Dewey in 20X5.

b. Compute the amount reported by Jimm as other comprehensive income in 20X5.

c. If all of Jimm's other comprehensive income arose solely from its investment in available-for-sale securities purchased on March 10, 20X5, for $130,000, what was the market value of those securities at December 31, 20X5?

LO 2-3, 2-7

P2-22A Equity-Method Income Statement

Wealthy Manufacturing Company purchased 40 percent of the voting shares of Diversified Products Corporation on March 23, 20X4. On December 31, 20X8, Wealthy Manufacturing's controller attempted to prepare income statements and retained earnings statements for the two companies using the following summarized 20X8 data:

	Wealthy Manufacturing	Diversified Products
Net Sales	$850,000	$400,000
Cost of Goods Sold	670,000	320,000
Other Expenses	90,000	25,000
Dividends Declared & Paid	30,000	10,000
Retained Earnings, 1/1/X8	420,000	260,000

Wealthy Manufacturing uses the equity method in accounting for its investment in Diversified Products. The controller was also aware of the following specific transactions for Diversified Products in 20X8, which were not included in the preceding data:

1. On June 30, 20X8, Diversified incurred a $5,000 extraordinary loss from a volcanic eruption near its Greenland facility.
2. Diversified sold its entire Health Technologies division on September 30, 20X8, for $375,000. The book value of Health Technologies division's net assets on that date was $331,000. The division incurred an operating loss of $15,000 in the first nine months of 20X8.
3. During 20X8, Diversified sold one of its delivery trucks after it was involved in an accident and recorded a gain of $10,000.

Required

a. Prepare an income statement and retained earnings statement for Diversified Products for 20X8.

b. Prepare an income statement and retained earnings statement for Wealthy Manufacturing for 20X8.

LO 2-3, 2-6, 2-7

P2-23 Consolidated Worksheet at End of the First Year of Ownership (Equity Method)

Peanut Company acquired 100 percent of Snoopy Company's outstanding common stock for $300,000 on January 1, 20X8, when the book value of Snoopy's net assets was equal to $300,000. Peanut uses the equity method to account for investments. Trial balance data for Peanut and Snoopy as of December 31, 20X8, are as follows:

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	Peanut Company		Snoopy Company	
	Debit	**Credit**	**Debit**	**Credit**
Cash	$ 130,000		$ 80,000	
Accounts Receivable	165,000		65,000	
Inventory	200,000		75,000	
Investment in Snoopy Stock	355,000		0	
Land	200,000		100,000	
Buildings & Equipment	700,000		200,000	
Cost of Goods Sold	200,000		125,000	
Depreciation Expense	50,000		10,000	
S&A Expense	225,000		40,000	
Dividends Declared	100,000		20,000	
Accumulated Depreciation		$ 450,000		$ 20,000
Accounts Payable		75,000		60,000
Bonds Payable		200,000		85,000
Common Stock		500,000		200,000
Retained Earnings		225,000		100,000
Sales		800,000		250,000
Income from Snoopy		75,000		0
Total	$2,325,000	$2,325,000	$715,000	$715,000

Required

a. Prepare the journal entries on Peanut's books for the acquisition of Snoopy on January 1, 20X8, as well as any normal equity method entry(ies) related to the investment in Snoopy Company during 20X8.

b. Prepare a consolidation worksheet for 20X8 in good form.

LO 2-3, 2-6, 2-7 **P2-24** **Consolidated Worksheet at End of the Second Year of Ownership (Equity Method)**

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Peanut Company acquired 100 percent of Snoopy Company's outstanding common stock for $300,000 on January 1, 20X8, when the book value of Snoopy's net assets was equal to $300,000. Problem 2-23 summarizes the first year of Peanut's ownership of Snoopy. Peanut uses the equity method to account for investments. The following trial balance summarizes the financial position and operations for Peanut and Snoopy as of December 31, 20X9:

	Peanut Company		Snoopy Company	
	Debit	**Credit**	**Debit**	**Credit**
Cash	$ 230,000		$ 75,000	
Accounts Receivable	190,000		80,000	
Inventory	180,000		100,000	
Investment in Snoopy Stock	405,000		0	
Land	200,000		100,000	
Buildings & Equipment	700,000		200,000	
Cost of Goods Sold	270,000		150,000	
Depreciation Expense	50,000		10,000	
Selling & Administrative Expense	230,000		60,000	
Dividends Declared	225,000		30,000	
Accumulated Depreciation		$ 500,000		$ 30,000
Accounts Payable		75,000		35,000
Bonds Payable		150,000		85,000
Common Stock		500,000		200,000
Retained Earnings		525,000		155,000
Sales		850,000		300,000
Income from Snoopy		80,000		0
Total	$2,680,000	$2,680,000	$805,000	$805,000

Required

a. Prepare any equity method journal entry(ies) related to the investment in Snoopy Company during 20X9.

b. Prepare a consolidation worksheet for 20X9 in good form.

LO 2-3, 2-6, 2-7 **P2-25** **Consolidated Worksheet at End of the First Year of Ownership (Equity Method)**

Paper Company acquired 100 percent of Scissor Company's outstanding common stock for $370,000 on January 1, 20X8, when the book value of Scissor's net assets was equal to $370,000. Paper uses the equity method to account for investments. Trial balance data for Paper and Scissor as of December 31, 20X8, are as follows:

	Paper Company		Scissor Company	
	Debit	**Credit**	**Debit**	**Credit**
Cash	$ 122,000		$ 46,000	
Accounts Receivable	140,000		60,000	
Inventory	190,000		120,000	
Investment in Scissor Stock	438,000		0	
Land	250,000		125,000	
Buildings & Equipment	875,000		250,000	
Cost of Goods Sold	250,000		155,000	
Depreciation Expense	65,000		12,000	
Selling & Administrative Expense	280,000		50,000	
Dividends Declared	80,000		25,000	
Accumulated Depreciation		$ 565,000		$ 36,000
Accounts Payable		77,000		27,000
Bonds Payable		250,000		100,000
Common Stock		625,000		250,000
Retained Earnings		280,000		120,000
Sales		800,000		310,000
Income from Scissor		93,000		0
Total	$2,690,000	$2,690,000	$843,000	$843,000

Required

a. Prepare the journal entries on Paper's books for the acquisition of Scissor on January 1, 20X8 as well as any normal equity method entry(ies) related to the investment in Scissor Company during 20X8.

b. Prepare a consolidation worksheet for 20X8 in good form.

LO 2-3, 2-6, 2-7 **P2-26** **Consolidated Worksheet at End of the Second Year of Ownership (Equity Method)**

Paper Company acquired 100 percent of Scissor Company's outstanding common stock for $370,000 on January 1, 20X8, when the book value of Scissor's net assets was equal to $370,000. Problem 2-25 summarizes the first year of Paper's ownership of Scissor. Paper uses the equity method to account for investments. The following trial balance summarizes the financial position and operations for Paper and Scissor as of December 31, 20X9:

	Paper Company		Scissor Company	
	Debit	**Credit**	**Debit**	**Credit**
Cash	$232,000		$116,000	
Accounts Receivable	165,000		97,000	
Inventory	193,000		115,000	
Investment in Scissor Stock	515,000		0	
Land	250,000		125,000	
Buildings & Equipment	875,000		250,000	
Cost of Goods Sold	$278,000		$178,000	
Depreciation Expense	65,000		12,000	
Selling & Administrative Expense	312,000		58,000	
Dividends Declared	90,000		30,000	

(continued)

Accumulated Depreciation		$ 630,000		$ 48,000
Accounts Payable		85,000		40,000
Bonds Payable		150,000		100,000
Common Stock		625,000		250,000
Retained Earnings		498,000		188,000
Sales		880,000		355,000
Income from Scissor		107,000		0
Total	$2,975,000	$2,975,000	$981,000	$981,000

Required

a. Prepare any equity method journal entry(ies) related to the investment in Scissor Company during 20X9.

b. Prepare a consolidation worksheet for 20X9 in good form.

LO 2-2, 2-6, 2-7

P2-27B Consolidated Worksheet at End of the First Year of Ownership (Cost Method)

Peanut Company acquired 100 percent of Snoopy Company's outstanding common stock for $300,000 on January 1, 20X8, when the book value of Snoopy's net assets was equal to $300,000. Peanut uses the cost method to account for investments. Trial balance data for Peanut and Snoopy as of December 31, 20X8, are as follows:

	Peanut Company		Snoopy Company	
	Debit	**Credit**	**Debit**	**Credit**
Cash	$ 130,000		$ 80,000	
Accounts Receivable	165,000		65,000	
Inventory	200,000		75,000	
Investment in Snoopy Stock	300,000		0	
Land	200,000		100,000	
Buildings & Equipment	700,000		200,000	
Cost of Goods Sold	200,000		125,000	
Depreciation Expense	50,000		10,000	
Selling & Administrative Expense	225,000		40,000	
Dividends Declared	100,000		20,000	
Accumulated Depreciation		$ 450,000		$ 20,000
Accounts Payable		75,000		60,000
Bonds Payable		200,000		85,000
Common Stock		500,000		200,000
Retained Earnings		225,000		100,000
Sales		800,000		250,000
Dividend Income		20,000		0
Total	$2,270,000	$2,270,000	$715,000	$715,000

Required

a. Prepare the journal entries on Peanut's books for the acquisition of Snoopy on January 1, 20X8 as well as any normal cost method entry(ies) related to the investment in Snoopy Company during 20X8.

b. Prepare a consolidation worksheet for 20X8 in good form.

LO 2-2, 2-6, 2-7

P2-28B Consolidated Worksheet at End of the Second Year of Ownership (Cost Method)

Peanut Company acquired 100 percent of Snoopy Company's outstanding common stock for $300,000 on January 1, 20X8, when the book value of Snoopy's net assets was equal to $300,000.

Problem 2-27 summarizes the first year of Peanut's ownership of Snoopy. Peanut uses the cost method to account for investments. The following trial balance summarizes the financial position and operations for Peanut and Snoopy as of December 31, 20X9:

	Peanut Company		Snoopy Company	
	Debit	**Credit**	**Debit**	**Credit**
Cash	$ 230,000		$ 75,000	
Accounts Receivable	190,000		80,000	
Inventory	180,000		100,000	
Investment in Snoopy Stock	300,000		0	
Land	200,000		100,000	
Buildings & Equipment	700,000		200,000	
Cost of Goods Sold	270,000		150,000	
Depreciation Expense	50,000		10,000	
Selling & Administrative Expense	230,000		60,000	
Dividends Declared	225,000		30,000	
Accumulated Depreciation		$ 500,000		$ 30,000
Accounts Payable		75,000		35,000
Bonds Payable		150,000		85,000
Common Stock		500,000		200,000
Retained Earnings		470,000		155,000
Sales		850,000		300,000
Dividend Income		30,000		0
Total	$2,575,000	$2,575,000	$805,000	$805,000

Required

a. Prepare any cost method journal entry(ies) related to the investment in Snoopy Company during 20X9.

b. Prepare a consolidation worksheet for 20X9 in good form.

Kaplan CPA Review

Kaplan CPA Review Simulation on Comprehensive Consolidation Procedures

Please visit the text website for the online Kaplan CPA Review task-based simulation: www.mhhe.com/christensen10e

Situation

For each parent-subsidiary relationship, determine the proper accounting treatment.

Topics Covered in the Simulation

a. Consolidation requirements.

b. Consolidation exceptions.