Consolidations – Changes in Ownership Transactions

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GENERAL OVERVIEW

The following topics are discussed in this chapter:

1. Subsidiary preferred stock outstanding
2. Changes in the parent's ownership interest in the subsidiary
3. Multiple ownership levels
4. Reciprocal or mutual ownership
5. Subsidiary stock dividends

SUBSIDIARY PREFERRED STOCK OUTSTANDING

- Preferred stockholders normally have preference over common shareholders with respect to dividends and the distribution of assets in a liquidation
  - The right to vote usually is withheld
  - Special attention must be given to the claim of a subsidiary's preferred shareholders on the net assets of the subsidiary

Consolidation with subsidiary preferred stock outstanding

- The amount of subsidiary stockholders' equity accruing to preferred shareholders must be determined before dealing with the elimination of the intercompany common stock ownership
- If the parent holds some of the subsidiary's preferred stock, its portion of the preferred stock interest must be eliminated
- Any portion of the subsidiary's preferred stock interest not held by the parent is assigned to the noncontrolling interest

Subsidiary Preferred Stock Outstanding - Illustration

1. Peerless Products acquires 80 percent of Special Foods’ common stock on January 1, 20X1, at its book value of $240,000 and accounts for the investment using the basic equity method. At the date of combination, the fair value of Special Foods’ common stock held by the noncontrolling shareholders is equal to its book value of $60,000.

2. Peerless earns income from its own operations of $140,000 in 20X1 and declares dividends of $60,000.

3. Special Foods reports net income of $50,000 in 20X1 and declares common dividends of $30,000.

4. On January 1, 20X1, immediately after the combination, Special Foods issues $100,000 of 12 percent preferred stock at par value, none of which is purchased by Peerless. The regular $12,000 preferred dividend is paid in 20X1.

- Allocation of Special Foods’ net income

Of the total $50,000 of net income reported by Special Foods for 20X1, $12,000 ($100,000 x .12) is assigned to the preferred shareholders as their current dividend. Peerless records its share of the remaining amount:

Special Foods’ net income, 20X1	**$50,000**
Less: Preferred dividends ($100,000 x .12)	**(12,000)**
Special Foods’ income accruing to common shareholders	**38,000**
Peerless’s proportionate share	**X 0.80**
Peerless’s income from Special Foods	**$30,400**

Income assigned to the noncontrolling interest for 20X1:

Preferred dividends of Special Foods	$12,000
In come assigned to Special Foods’ noncontrolling common shareholders ($38,000 x .20)	7,600
Income to noncontrolling interest	$19,600

Computation and allocation of consolidated net income:

Peerless's separate operating income	$140,000
Special Foods' net income	50,000
Consolidated net income	$190,000
Income to the noncontrolling interest	(19,600)
Income attributed to the controlling interest	$170,400

The workpaper to prepare consolidated financial statements at the end of 20X1 appears in Figure 9–1 in the text.

Elimination entries:

		Debit	Credit
E(1)	**Income from Subsidiary**	**30,400**	
	Dividends Declared—Common		**24,000**
	Investment in Special Foods Common		**6,400**
	Eliminate income from subsidiary.		
E(2)	**Income to Noncontrolling Interest**	**19,600**	
	Dividends Declared—Preferred		**12,000**
	Dividends Declared—Common		**6,000**
	Noncontrolling Interest		**1,600**
	Assign income to noncontrolling interest.		
E(3)	**Common Stock—Special Foods**	**200,000**	
	Retained Earnings, January 1	**100,000**	
	Investment in Special Foods Common		**240,000**
	Noncontrolling Interest		**60,000**
	Eliminate beginning investment in common stock.		
E(4)	**Preferred Stock—Special Foods**	**100,000**	
	Noncontrolling Interest		**100,000**
	Eliminate subsidiary preferred stock.		

SUBSIDIARY PREFERRED STOCK OUTSTANDING

Subsidiary preferred stock held by parent

- Because the preferred stock held by the parent is within the consolidated entity, it must be eliminated when consolidated financial statements are prepared
- Any income from the preferred stock recorded by the parent also must be eliminated

Peerless acquires 60 percent of Special Foods' $100,000 par value, 12 percent preferred stock for $60,000 when issued on January 1, 20X1. During 20X1 dividends of $12,000 are declared on the preferred stock. Peerless recognizes $7,200 of dividend income from its investment in preferred stock, and the remaining $4,800 is paid to the holders of the other preferred shares.

Noncontrolling interest's share of preferred dividends ($12,000 x .40)	$4,800
In come assigned to Special Foods' noncontrolling common shareholders ($38,000 x .20)	7,600
Income to noncontrolling interest	$12,400

Elimination entries:

E(5)	**Income from Subsidiary**	**30,400**	
	Dividends Declared—Common		**24,000**
	Investment in Special Foods Common		**6,400**
	Eliminate income from subsidiary: $30,400 = ($50,000 - $12,000) x .80		
(E(6)	**Dividend Income—Preferred**	**7,200**	
	Dividends Declared—Preferred		**7,200**
	Eliminate dividend income from subsidiary preferred: $12,000 x .60		

Elimination entries (continued):			
E(7)	**Income to Noncontrolling Interest**	**12,400**	
	Dividends Declared—Preferred		**4,800**
	Dividends Declared—Common		**6,000**
	Noncontrolling Interest		**1,600**
	Assign income to noncontrolling interest:		
	$12,400 = $4,800 + $7,600		
	$4,800 = $12,000 x .40		
E(8)	**Common Stock—Special Foods**	**200,000**	
	Retained Earnings, January 1	**100,000**	
	Investment in Special Foods Common		**240,000**
	Noncontrolling Interest		**60,000**
	Eliminate beginning investment in common stock.		
E(9)	**Preferred Stock—Special Foods**	**100,000**	
	Investment in Special Foods Preferred		**60,000**
	Noncontrolling Interest		**40,000**
	Eliminate subsidiary preferred stock.		

Subsidiary preferred stock with special provisions

- The provisions of the preferred stock agreement must be examined to determine the portion of the subsidiary's stockholders' equity to be assigned to the preferred stock interest
  - Cumulative dividend provision
  - Noncumulative preferred stock
  - Preferred stock participation features
  - Preferred stocks that are callable

Illustration of Subsidiary Preferred Stock with Special Features

1. Special Foods issues $100,000 par value 12 percent preferred stock on January 1, 20X0. It is cumulative, nonparticipating, and callable at 105.
2. No dividends are declared on the preferred stock during 20X0.
3. On January 1, 20X1, Peerless Products acquires 80 percent of Special Foods' common stock for $240,000, when the fair value of the noncontrolling interest in Special Foods' common stock is $60,000.
4. On January 1, 20X1, Peerless acqiures 60 percent of the preferred stock for $61,000.
5. Stockholders' equity accounts of Special Foods on January 1, 20X1 follow:

Preferred Stock	$100,000
Common Stock	200,000
Retained Earnings	100,000
Total Stockholders' Equity	$400,000

Peerless acquires 60 percent of Special Foods' $100,000 par value, 12 percent preferred stock for $60,000 when issued on January 1, 20X1. During 20X1 dividends of $12,000 are declared on the preferred stock. Peerless recognizes $7,200 of dividend income from its investment in preferred stock, and the remaining $4,800 is paid to the holders of the other preferred shares.

Par value of Special Foods' preferred stock	$100,000
Call premium	5,000
Dividends in arrears for 20X0	12,000
Total preferred stock interest, January 1, 20X1	$117,000

This amount is apportioned between Peerless and the noncontrolling shareholders:

Peerless's share of preferred stock interest ($117,000 x .60)	$70,200
Noncontrolling stockholders' share of preferred stock interest ($117,000 x .40)	46,800
Total preferred stock interest, January 1, 20X1	$117,000

Because the preferred stock interest exceeds the par value by $17,000, the portion of Special Foods' retained earnings accruing to the common shareholders is reduced by that amount. Therefore, Special Foods' common stockholders have a total claim on the company's net assets as follows:

Common stock	$200,000
Retained earnings ($100,000 - $17,000)	83,000
Total common stock interest, January 1, 20X1	$283,000

Because the book value of Special Foods' common stock is only $283,000 on January 1, 20X1, a differential arises:

Consideration given by Peerless Products	$240,000
Fair value of noncontrolling interest in Special Foods' common stock	60,000
	$300,000
Book value of Special Foods' common stock	(283,000)
Differential	$17,000

Eliminating entries:

		Debit	Credit
E(10)	**Common Stock—Special Foods**	**200,000**	
	Retained Earnings	**83,000**	
	Differential	**17,000**	
	Investment in Special Foods Common		**240,000**
	Noncontrolling Interest		**60,000**

Eliminate investment in common stock:

$83,000 = $100,000 - $17,000

$17,000 = $300,000 - $283,000

		Debit	Credit
E(11)	**Preferred Stock—Special Foods**	**100,000**	
	Retained Earnings	**17,000**	
	Investment in Special Foods Preferred		**61,000**
	Additional Paid-In Capital		**9,200**
	Noncontrolling Interest		**46,800**

Eliminate subsidiary preferred stock:

$17,000 = $117,000 - $100,000

$9,200 = ($117,000 x .60) - $61,000

$46,800 = $117,000 x .40

CHANGES IN PARENT COMPANY OWNERSHIP

- Parent's purchase of additional shares from nonaffiliate
  - Effects of multiple purchases of a subsidiary's stock on the consolidation process are illustrated in the following example:

Assume that on January 1, 20X0, Special Foods has $200,000 of common stock outstanding and retained earnings of $60,000. During 20X0, 20X1, and 20X2, Special Foods reports the following information:

Period	Net Income	Dividends	Ending Book Value
20X0	$40,000	-0-	$300,000
20X1	50,000	$30,000	320,000
20X2	75,000	40,000	355,000

Changes in Parent Company Ownership - Illustration

Peerless Products purchases its 80 percent interest in Special Foods in several blocks, as follows:

Purchase Date	Ownership Percentage Acquired	Cost	Book Value	Differential
January 1, 20X0	20	$ 56,000	$ 52,000	$ 4,000
December 31, 20X0	10	35,000	30,000	5,000
January 1, 20X2	50	185,000	160,000	
	80			

All of the differential relates to land held by Special Foods. Note that Peerless does not gain control of Special Foods until January 1, 20X2.

The investment account on Peerless's books includes the following amounts through 20X1:

20X0	
Purchase shares (January 1)	$ 56,000
Equity-method income ($40,000 × .20)	8,000
Purchase of shares (December 31)	35,000
Balance in investment account (December 31)	$ 99,000
20X1	
Equity-method income ($50,000 × .30)	15,000
Dividends received ($30,000 × .30)	(9,000)
Balance in investment account (December 31)	$105,000

Changes in Parent Company Ownership - Illustration

When Peerless gains control of Special Foods on January 1, 20X2, assume that the fair value of the 30 percent equity interest it already holds in Special Foods is $111,000, and the fair value of Special Foods' 20 percent remaining noncontrolling interest is $74,000. The book value of Special Foods as a whole on that date is $320,000. Under **FASB 141R**, the differential at the date of combination is computed as follows:

Fair value of consideration exchanged	$185,000
Fair value of equity interest already held	111,000
Fair value of noncontrolling interest	74,000
	$370,000
Book value of Special Foods	(320,000)
Differential	$ 50,000

Because all of the differential relates to land, it is not amortized or written off either on Peerless's books or for consolidation.

Under **FASB 141R**, Peerless must remeasure the equity interest it already held in Special Foods to its fair value at the date of combination and recognize a gain or loss for the difference between the fair value and its carrying amount:

Fair value of equity interest already held	$111,000
Carrying amount of investment, December 31, 20X1	(105,000)
Gain on increase in value of investment in Special Foods	$ 6,000

The total balance of the investment account on Peerless's books immediately after the combination is:

Carrying amount of investment, December 31, 20X1	$105,000
Increase in value of investment in Special Foods	6,000
Cost of January 1, 20X2, shares acquired	185,000
Peerless's total recorded amount of investment	$296,000

Because Peerless Products gains control of Special Foods on January 1, 20X2, consolidated statements are prepared for the year 20X2.

Eliminating entries:

E(12)	**Income from Subsidiary**	**60,000**	
	Dividends Declared		**32,000**
	Investment in Special Foods Stock		**28,000**
	Eliminate income from subsidiary.		
E(13)	**Income to Noncontrolling Interest**	**15,000**	
	Dividends Declared		**8,000**
	Noncontrolling Interest		**7,000**
	Assign income to noncontrolling shareholders: $15,000 = $75,000 x .20 $8,000 = $40,000 x .20 $7,000 = $15,000 - $8,000		
E(14)	**Common Stock—Special Foods**	**200,000**	
	Retained Earnings, January 1	**120,000**	
	Land	**50,000**	
	Investment in Special Foods Stock		**296,000**
	Noncontrolling Interest		**74,000**
	Eliminate beginning investment balance:		

Changes in Parent Company Ownership

- Parent's sale of subsidiary shares to nonaffiliate
  - When a parent sells some shares of a subsidiary but continues to hold a controlling interest, **FASB 160** makes clear that this is considered to be an equity transaction and no gain or loss may be recognized in consolidated net income
  - An adjustment is required to the amount assigned to the noncontrolling interest to reflect its change in ownership of the subsidiary

Changes in Parent Company Ownership

- The difference between the fair value of the consideration exchanged and the adjustment to the noncontrolling interest results in an adjustment to the stockholders' equity attributable to the controlling interest
- Some parent companies might choose to recognize a gain on their separate books
  - A better alternative is to avoid recognizing a gain that later will have to be eliminated and instead recognize an increase in additional paid-in capital

Changes in Parent Company Ownership

- Subsidiary's sale of additional shares to nonaffiliate
  - Increases the total stockholders' equity of the consolidated entity by the amount received by the subsidiary from the sale
  - Increases the subsidiary's total shares outstanding and reduces the percentage ownership held by the parent
  - The dollar amount assigned to the noncontrolling interest in the consolidated financial statements increases

Changes in Parent Company Ownership

- The resulting amounts of the controlling and noncontrolling interests are affected by two factors:
  1. The number of shares sold to nonaffiliates
  2. The price at which the shares are sold to nonaffiliates

Changes in Parent Company Ownership

- Difference between book value and sale price of subsidiary shares
  - If the sale price of new shares equals the book value of outstanding shares, there is no change in the existing shareholders' claim
  - The consolidation eliminating entries are changed to recognize the increase in the claim of the noncontrolling shareholders and the corresponding increase in the stockholders' equity balances of the subsidiary

Changes in Parent Company Ownership

- When the sale price and book value are not the same:
  - All common shareholders are assigned a pro rata portion of the difference
  - The book value of the subsidiary's shares held by the parent changes
  - This change is recognized by the parent by adjusting the carrying amount of its investment in the subsidiary and additional paid-in capital
  - The parent's additional paid-in capital is then carried to the workpaper in consolidation

Changes in Parent Company Ownership

- Subsidiary's sale of additional shares to parent at a price equal to the book value of the existing shares
  - A sale of additional shares directly from a less-than-wholly owned subsidiary to its parent increases the parent's ownership percentage
  - The increase in the parent's investment account equals the increase in the stockholders' equity of the subsidiary
  - The net book value assigned to the noncontrolling interest remains unchanged
  - Normal elimination entries are made based on the parent's new ownership percentage

Changes in Parent Company Ownership

- Subsidiary's sale of additional shares to parent at an amount other than book value
  - It increases the carrying amount of its investment by the fair value of the consideration given
  - In consolidation, the amount of the noncontrolling interest must be adjusted to reflect the change in its interest in the subsidiary
  - FASB 160 then requires an adjustment to consolidated additional paid-in capital for the difference between any consideration given or received by the consolidated entity and the amount of the adjustment to the noncontrolling interest

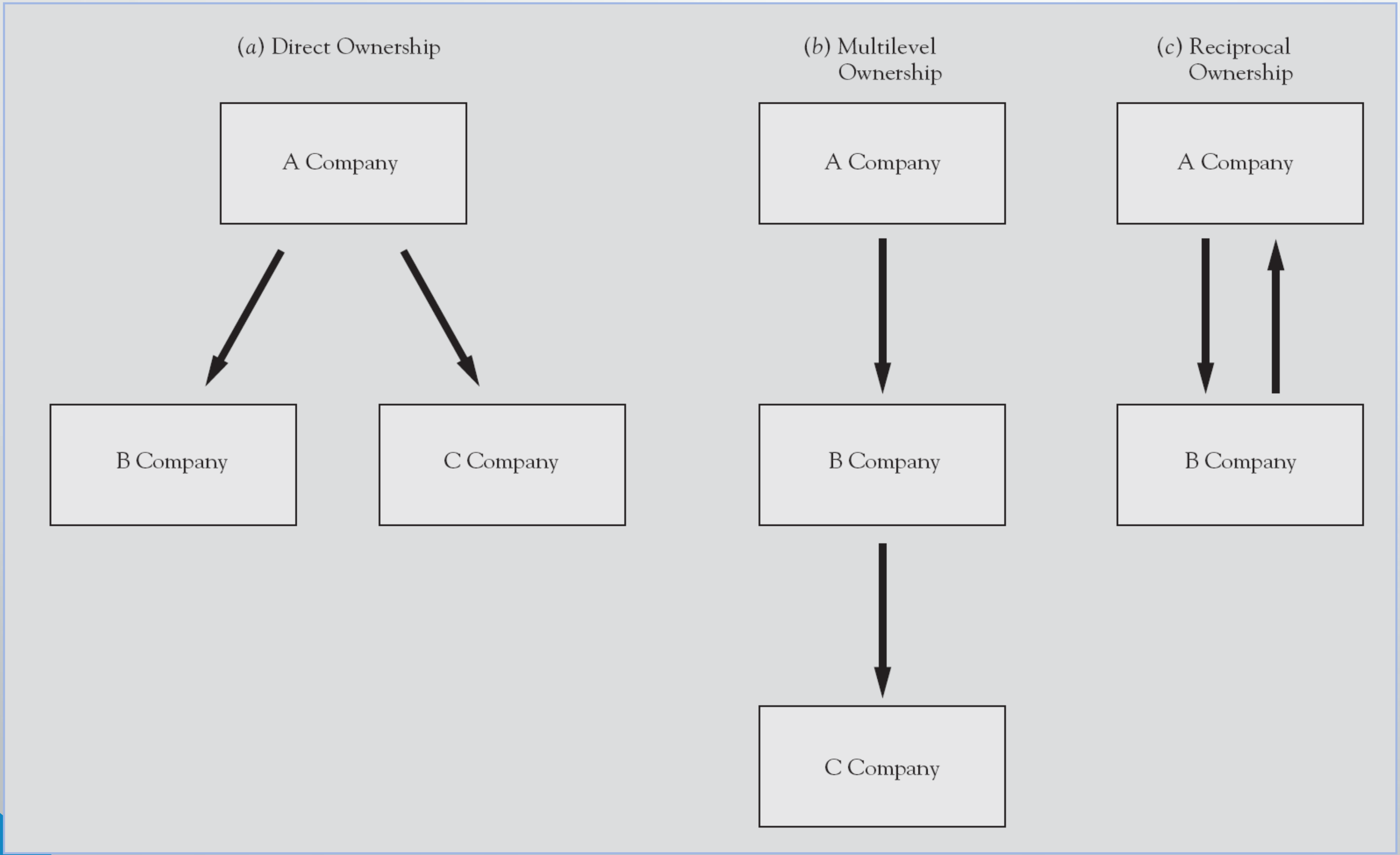
Changes in Parent Company Ownership

- Subsidiary's purchase of shares from nonaffiliate
  - Sometimes a subsidiary purchases treasury shares from noncontrolling shareholders, who may be willing sellers
  - The parent's equity in the net assets of the subsidiary may change as a result of the transaction
  - When this occurs, the amount of the change must be recognized in preparing the consolidated statements

Changes in Parent Company Ownership

- Subsidiary's purchase of shares from parent
  - When this happens, the parent has traditionally recognized a gain or loss on the difference between the selling price and the change in the carrying amount of its investment
  - From a consolidated viewpoint, the transaction represents an internal transfer and does not give rise to a gain or loss
  - A better approach is for the parent to adjust additional paid-in capital

Complex Ownership Structures



- **Direct ownership**: The parent has controlling interest in each of the subsidiaries
- **Multilevel ownership**: The parent has only indirect control over the company controlled by its subsidiary
    - The eliminating entries used are similar to those used in a simple ownership situation, but careful attention must be given to the sequence in which the data are brought together

Reciprocal ownership or **mutual holdings**:

- The parent owns a majority of the subsidiary’s common stock and the subsidiary holds some of the parent’s common shares
- If mutual shareholdings are ignored in consolidation, some reported amounts may be materially overstated

COMPLEX OWNERSHIP STRUCTURES

- Multilevel ownership and control
  - When consolidated statements are prepared, they include companies in which the parent has only an indirect investment along with those in which it holds direct ownership
  - The complexity of the consolidation process increases as additional ownership levels are included
  - The amount of income and net assets to be assigned to the controlling and noncontrolling shareholders, and the amount of unrealized profits and losses to be eliminated, must be determined at each level of ownership

- When a number of different levels of ownership exist, the first step normally is to consolidate the bottom, or most remote, subsidiaries with the companies at the next higher level
- This sequence is continued up through the ownership structure until the subsidiaries owned directly by the parent company are consolidated with it
- Income is apportioned between the controlling and noncontrolling shareholders of the companies at each level

Reciprocal or Mutual Ownership

- The treasury stock method is used to deal with reciprocal relationships
  - Purchases of a parent's stock by a subsidiary are treated in the same way as if the parent had repurchased its own stock and was holding it in the treasury
  - The subsidiary normally accounts for the investment in the parent's stock using the cost method

SUBSIDIARY STOCK DIVIDENDS

- Stock dividends are issued proportionally to all common stockholders
  - The relative interests of the controlling and noncontrolling stockholders do not change
  - The investment's carrying amount on the parent's books also is unaffected
  - The stockholders' equity accounts of the subsidiary do change, although total stockholders' equity does not

The stock dividend represents a permanent capitalization of retained earnings, thus:

- Decreasing retained earnings and increasing capital stock and, perhaps, additional paid-in capital
- Effect on the preparation of consolidated financial statements for the period:
  - The stock dividend declaration must be eliminated along with the increased common stock and increased additional paid-in capital, if any

- In subsequent years, the balances in the subsidiary's stockholders' equity accounts are eliminated in the normal manner
- The full balances of all the subsidiary's stockholders' equity accounts must be eliminated in consolidation, even though amounts have been shifted from one account to another

THANK YOU