# Subsidiary Preferred Stock, Consolidated Earning per Share, and Taxation

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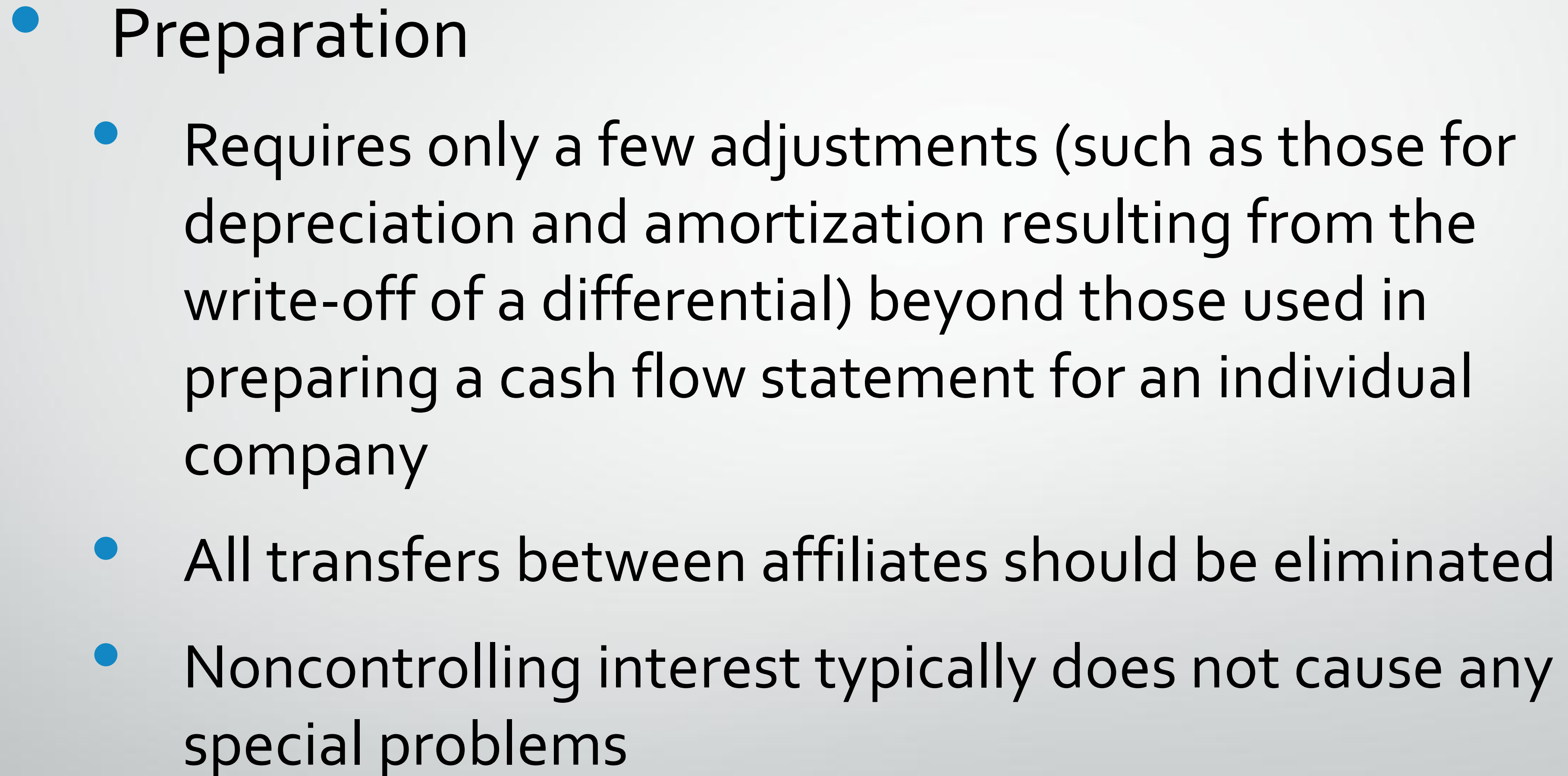
# GENERAL OVERVIEW

This chapter discusses the following general financial reporting topics as they relate to consolidated financial statements:

1. The consolidated statement of cash flows
2. Consolidation following an interim acquisition
3. Consolidation tax considerations
4. Consolidated earnings per share

# CONSOLIDATED STATEMENT OF CASH FLOWS

- A consolidated statement of cash flows is similar to a statement of cash flows prepared for a single-corporate entity and is prepared in basically the same manner
- Preparation
  - Typically prepared after the consolidated income statement, retained earnings statement, and balance sheet
  - Prepared from the information in the other three statements

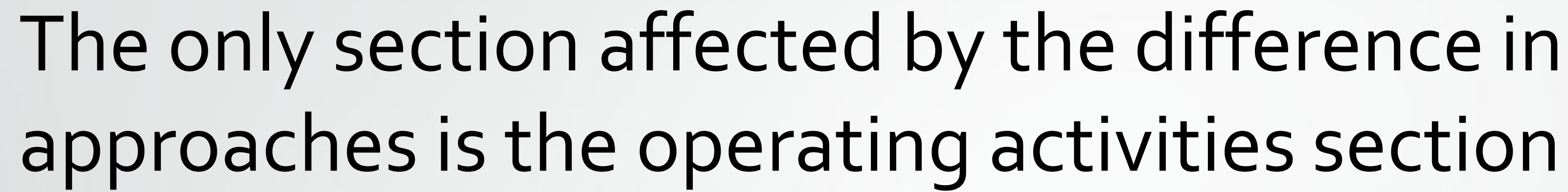

• Preparation
• Requires only a few adjustments (such as those for depreciation and amortization resulting from the write-off of a differential) beyond those used in preparing a cash flow statement for an individual company
• All transfers between affiliates should be eliminated
• Noncontrolling interest typically does not cause any special problems

# Consolidated Statement of Cash Flows for the Year Ended December 31, 20X2 (Figure10–2)

**PEERLESS PRODUCTS CORPORATION AND SUBSIDIARY**
**Consolidated Statement of Cash Flows**
**For the Year Ended December 31, 20X2**

| | | |
|---|---|---|
| Cash Flows from Operating Activities: | | |
| Consolidated Net Income | $ 229,000 | |
| Noncash Expenses, Revenues, Losses, and Gains included in Income: | | |
| Depreciation Expense | 76,000 | |
| Gain on Sale of Land | (30,000) | |
| Increase in Accounts Receivable | (105,000) | |
| Increase in Inventory | (95,000) | |
| Increase in Accounts Payable | 30,000 | |
| Net Cash Provided by Operating Activities | | $105,000 |
| Cash Flows from Investing Activities: | | |
| Acquisition of Equipment | $(100,000) | |
| Sale of Land | 70,000 | |
| Net Cash Used in Investing Activities | | (30,000) |
| Cash Flows from Financing Activities: | | |
| Dividends Paid: | | |
| To Parent Company Shareholders | $ (60,000) | |
| To Noncontrolling Shareholders | (8,000) | |
| Net Cash Used in Financing Activities | | (68,000) |
| Net Increase in Cash | | $ 7,000 |
| Cash at Beginning of Year | | 269,000 |
| Cash at End of Year | | $276,000 |

- Nearly all major companies use the indirect method
- Critics have argued that the direct method is less confusing and more useful



## The only section affected by the difference in approaches is the operating activities section

- Under the indirect approach, the operating activities section starts with net income and, to derive cash provided by operating activities, adjusts for all items affecting cash and net income differently
- Under the direct approach, the operating activities section of the statement shows the actual cash flows

- Direct approach - As an example, the only cash flows related to operations are:

| Cash Flows from Operating Activities: | |
| --- | --- |
| Cash Received from Customers | $615,000 |
| Cash Paid to Suppliers | (510,000) |
| Net Cash Provided by Operating Activities | $105,000 |

- The remainder of the cash flow statement is the same under both approaches except that a separate reconciliation of operating cash flows and net income is required under the direct approach

# CONSOLIDATION FOLLOWING AN INTERIM ACQUISITION

When a subsidiary is acquired during a fiscal period, the results of the subsidiary’s operations are included in the consolidated statements only for the portion of the year that the stock is owned by the parent

# Consolidation Following an Interim Acquisition - Illustration

Assume that on July 1, 20X1, Peerless Products purchases 80 percent of Special Foods' common stock for its underlying book value of $246,400. At the time of acquisition, the $61,600 fair value of Special Foods' noncontrolling interest is equal to its book value. For the year 20X1, Special Foods reports the following items:

| | Before Combination (January 1 to June 30) | After Combination (July 1 to December 31) |
|---|---|---|
| Sales | $80,000 | $120,000 |
| Cost of Goods Sold | 46,000 | 69,000 |
| Depreciation and Amortization | 8,000 | 12,000 |
| Other Expenses | 6,000 | 9,000 |
| Net Income | 20,000 | 30,000 |
| Dividends | 12,000 | 18,000 |

## The book value of Special Foods' stock acquired by Peerless on July 1, 20X1:

| | |
|---|---|
| Book value of Special Foods on January 1, 20X1: | |
| Common stock | $200,000 |
| Retained earnings | 100,000 |
| | $300,000 |
| Net income, January 1 to June 30, 20X1 | 20,000 |
| Dividends, January 1 to June 30, 20X1 | (12,000) |
| Book value of Special Foods on July 1, 20X1 | $308,000 |
| Peerless's ownership interest | × .80 |
| Book value on July 1, 20X1, of shares acquired by Peerless | $246,400 |

## The ownership situation on July 1, 20X1:

P → S: 7/1/X1 80%
NCI → S: 20%

| | | |
|---|---|---|
| Total fair value | | $308,000 |
| Book value (7/1/X1) | | |
| Common stock—Special Foods | $200,000 | |
| Retained earnings—Special Foods | 108,000 | |
| | | 308,000 |
| Differential | | $ -0- |

## Parent Company Entries

July 1, 20X1

| | Debit | Credit |
|---|---|---|
| **Investment in Special Foods Stock** | **246,400** | |
| **Cash** | | **246,400** |
| Record purchase of Special Foods stock. | | |

**Entries during the second half of 20x1:**

| | Debit | Credit |
|---|---|---|
| **Cash** | **14,400** | |
| **Investment in Special Foods Stock** | | **14,400** |
| Record dividends from Special Foods: $18,000 x .80 | | |
| **Investment in Special Foods Stock** | **24,000** | |
| **Income from Subsidiary** | | **24,000** |
| Record equity-method income: $30,000 x .80 | | |

**Eliminating entries:**

| | | Debit | Credit |
|---|---|---|---|
| E(4) | **Income from Subsidiary** | **24,000** | |
| | **Dividends Declared** | | **14,400** |
| | **Investment in Special Foods Stock** | | **9,600** |
| | Eliminate income from subsidiary. | | |
| E(5) | **Income to Noncontrolling Interest** | **6,000** | |
| | **Dividends Declared** | | **3,600** |
| | **Noncontrolling Interest** | | **2,400** |
| | Assign income to noncontrolling interest, from July 1: | | |
| | $6,000 = $30,000 x .20 | | |
| | $3,600 = $18,000 x .20 | | |
| E(6) | **Common Stock—Special Foods** | **200,000** | |
| | **Retained Earnings, January 1** | **100,000** | |
| | **Sales** | **80,000** | |
| | **Cost of Goods Sold** | | **46,000** |
| | **Depreciation and Amortization** | | **8,000** |
| | **Other Expenses** | | **6,000** |
| | **Dividends Declared** | | **12,000** |
| | **Investment in Special Foods Stock** | | **246,400** |
| | **Noncontrolling Interest** | | **61,600** |
| | Eliminate investment balance, subsidiary stockholders' equity, and subsidiary preacquisition income and dividends. | | |

The consolidation workpaper is presented in Figure 10–4 in the text.

**PEERLESS PRODUCTS CORPORATION AND SUBSIDIARY**
**Consolidated Income Statement**
**For the Year Ended December 31, 20X1**

| | | |
|---|---|---|
| Sales | | $520,000 |
| Cost of Goods Sold | | (239,000) |
| Gross Margin | | $281,000 |
| Expenses: | | |
| Depreciation and Amortization | $62,000 | |
| Other Expenses | 49,000 | |
| Total Expenses | | (111,000) |
| Consolidated Net Income | | $170,000 |
| Income Attributable to the Noncontrolling Interest | | (6,000) |
| Income Attributable to the Controlling Interest | | $164,000 |

# CONSOLIDATION INCOME TAX ISSUES

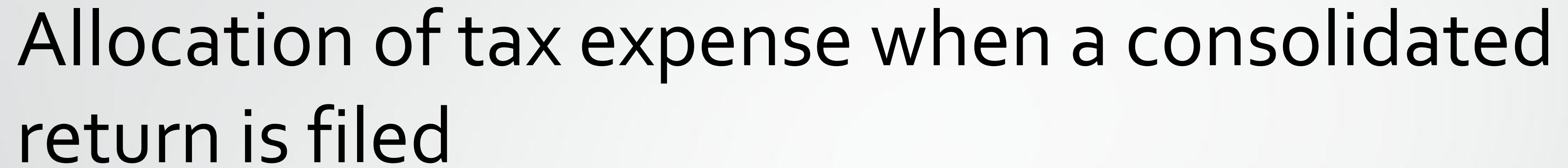
A parent company and its subsidiaries may file a consolidated income tax return, or they may choose to file separate returns

- For a subsidiary to be eligible to be included in a consolidated tax return, at least 80 percent of its stock must be held by the parent company or another company included in the consolidated return

# Filing a consolidated return - Advantages

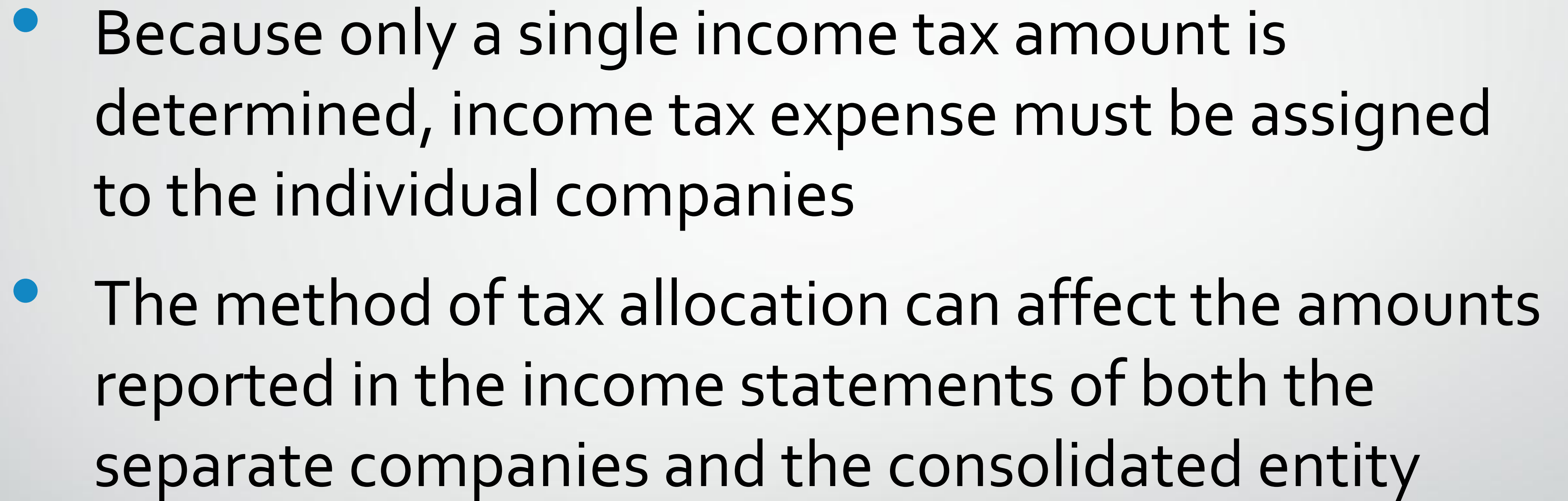
- The losses of one company may be offset against the profits of another
- Dividends and other transfers between the affiliated companies are not taxed
- May make it possible to avoid limits on the use of certain items such as foreign tax credits and charitable contributions

- Once an election is made to include a subsidiary in the consolidated return, the company cannot file separate tax returns in the future unless it receives IRS approval
- The subsidiary’s tax year also must be brought into conformity with the parent’s tax year
- Can become quite difficult when numerous companies are involved and complex ownership arrangements exist

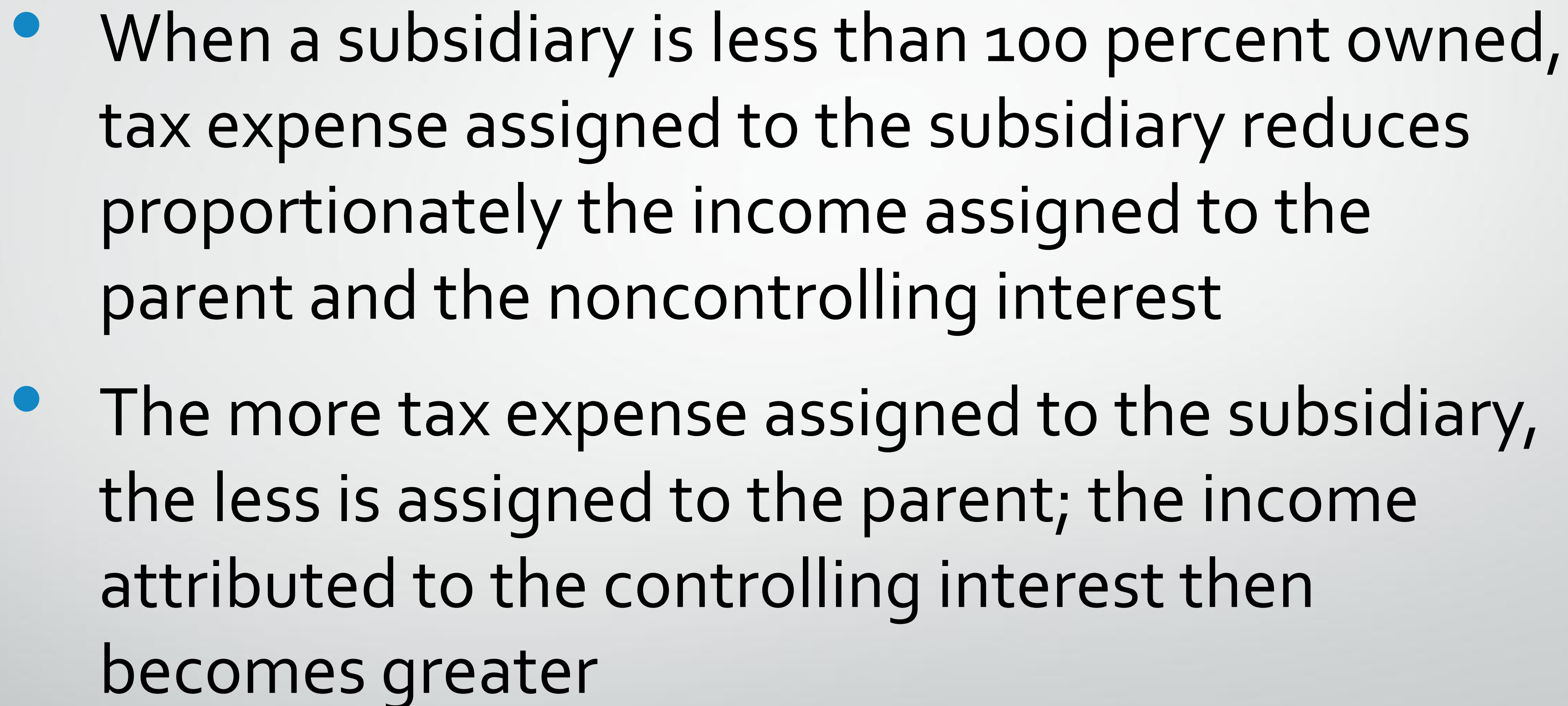


# Allocation of tax expense when a consolidated return is filed

- Portrays the companies included in the return as if they actually were a single legal entity
- All intercorporate transfers of goods and services and intercompany dividends are eliminated and a single income tax figure is assessed



- Because only a single income tax amount is determined, income tax expense must be assigned to the individual companies
- The method of tax allocation can affect the amounts reported in the income statements of both the separate companies and the consolidated entity



- When a subsidiary is less than 100 percent owned, tax expense assigned to the subsidiary reduces proportionately the income assigned to the parent and the noncontrolling interest
- The more tax expense assigned to the subsidiary, the less is assigned to the parent; the income attributed to the controlling interest then becomes greater

# Consolidation Income Tax Issues

Assume that Peerless owns 80 percent of the stock of Special Foods, acquired at book value, and the two companies elect to file a consolidated tax return for 20X1. Peerless reports operating earnings before taxes of $140,000, excluding income from Special Foods, and Special Foods reports income before taxes of $50,000. Consolidated income taxes are $76,000 ($190,000 x 40 percent tax rate).

| | | |
|---|---|---|
| Peerless Products: | ($140,000/$190,000) × $76,000 = | $56,000 |
| Special Foods: | ($50,000/$190,000) × $76,000 = | 20,000 |
| Consolidated tax expense | | $76,000 |

Income assigned to the noncontrolling interest is computed as:

| | |
|---|---|
| Special Foods' income before tax | $50,000 |
| Income tax expense assigned to Special Foods | (20,000) |
| Special Foods' net income | $30,000 |
| Noncontrolling stockholders' proportionate share | × .20 |
| Income assigned to noncontrolling interest | $ 6,000 |

Consolidated income statement for 20X1 shows the following amounts:

| | |
|---|---|
| Consolidated Operating Income | $190,000 |
| Less: Income Tax Expense | (76,000) |
| Consolidated Net Income | $114,000 |
| Income Attributed to Noncontrolling Interest | (6,000) |
| Income Attributed to Controlling Interest | $108,000 |

- Other allocation bases may be preferred when affiliates have significantly different tax characteristics

## Unrealized profits when a consolidated return is filed

- Intercompany transfers are eliminated in computing both consolidated net income and taxable income
- Because profits are taxed in the same period they are recognized for financial reporting purposes, no temporary differences arise, and no additional tax accruals are needed in preparing the consolidated financial statements

- The companies are taxed individually on the profits from intercompany sales
- No consideration is given to whether the intercompany profits are realized from a consolidated viewpoint

- The tax expense on the unrealized intercompany profit must be eliminated when the unrealized intercompany profit is eliminated in preparing consolidated financial statements
- This difference in timing of the tax expense recognition results in the recording of deferred income taxes

Special Foods sells inventory costing $23,000 to Peerless Products for $28,000, and none is resold before year-end. Assume 40 percent tax rate.

| **Eliminating entries:** | | | |
|---|---|---|---|
| E(7) | **Sales** | **28,000** | |
| | **Cost of Goods Sold** | | **23,000** |
| | **Inventory** | | **5,000** |
| | Eliminate intercompany upstream sale of inventory. | | |
| | | | |
| E(8) | **Deferred Tax Asset** | **2,000** | |
| | **Income Tax Expense** | | **2,000** |
| | Eliminate tax expense on unrealized intercompany profit. | | |

- This tax effect normally is carried to the consolidated balance sheet as an asset
- If the intercompany profit is expected to be recognized in the consolidated income statement in the next year, the deferred taxes are classified as current

# Unrealized Profit in Separate Tax Return Illustrated

1. Peerless owns 80 percent of Special Foods' common stock, acquired at book value.
2. During 20X1, Special Foods purchases inventory for $23,000 and sells it to Peerless for $28,000. Peerless continues to hold all of the inventory at the end of 20X1.
3. The effective combined federal and state tax rate for both Peerless and Special Foods is 40 percent.

| | |
|---|---|
| Special Foods' net income | $30,000 |
| Add back income tax expense | 20,000 |
| Special Foods' income before taxes | $50,000 |
| Unrealized profit on upstream sale | (5,000) |
| Special Foods' realized income before taxes | $45,000 |
| Income taxes on realized income (40%) | (18,000) |
| Special Foods' realized net income | $27,000 |
| Special Foods' realized net income assigned to: | |
| Controlling interest ($27,000 × .80) | $21,600 |
| Noncontrolling interest ($27,000 × .20) | 5,400 |
| Special Foods' realized net income | $27,000 |

**Eliminating entries:**

| | Account | Debit | Credit |
|---|---|---|---|
| E(9) | **Income from Subsidiary** | **24,000** | |
| | **Dividends Declared** | | **24,000** |
| | Eliminate income from subsidiary. | | |
| E(10) | **Income to Noncontrolling Interest** | **5,400** | |
| | **Noncontrolling Interest** | **600** | |
| | **Dividends Declared** | | **6,000** |
| | Assign income to noncontrolling interest. | | |
| E(11) | **Common Stock—Special Foods** | **200,000** | |
| | **Retained Earnings, January 1** | **100,000** | |
| | **Investment in Special Foods Stock** | | **240,000** |
| | **Noncontrolling Interest** | | **60,000** |
| | Eliminate beginning investment balance. | | |
| E(12) | **Sales** | **28,000** | |
| | **Cost of Goods Sold** | | **23,000** |
| | **Inventory** | | **5,000** |
| | Eliminate intercompany upstream sale of inventory. | | |
| E(13) | **Deferred Tax Asset** | **2,000** | |
| | **Income Tax Expense** | | **2,000** |
| | Eliminate tax expense on unrealized intercompany profit | | |

# Subsequent Profit Realization When Separate Returns Are Filed

If income taxes were ignored, eliminating entry E(14) would be used in preparing consolidated statements as of December 31, 20X2, assuming that Special Foods had $5,000 of unrealized inventory profit on its books on January 1, 20X2, and the inventory was resold in 20X2:

| | | Debit | Credit |
|---|---|---|---|
| E(14) | **Retained Earnings, January 1** | **4,000** | |
| | **Noncontrolling Interest** | **1,000** | |
| | **Cost of Goods Sold** | | **5,000** |
| | Eliminate beginning inventory profit. | | |

If the 40 percent tax rate is considered, eliminating entry E(15) is used:

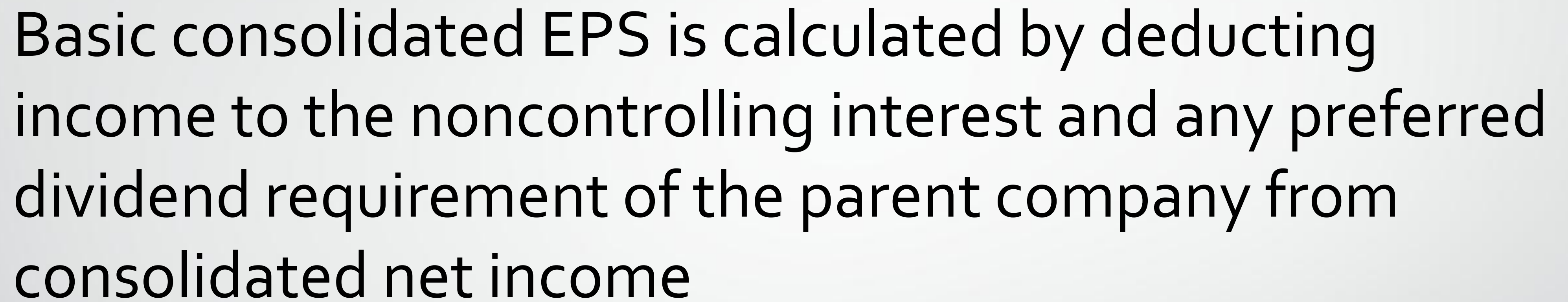
| | | | |
|---|---|---|---|
| E(15) | **Retained Earnings, January 1** | **2,400** | |
| | **Noncontrolling Interest** | **600** | |
| | **Income Tax Expense** | **2,000** | |
| | **Cost of Goods Sold** | | **5,000** |

Eliminate beginning inventory profit:
$2,400 = ($5,000 - $2,000) x .80
$600 = ($5,000 - $2,000) x .20
$2,000 = $5,000 x.40

# CONSOLIDATED EARNINGS PER SHARE

Basic consolidated EPS is calculated by deducting income to the noncontrolling interest and any preferred dividend requirement of the parent company from consolidated net income

- The resulting amount is then divided by the weighted-average number of the parent's common shares outstanding during the period



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- The resulting amount is then divided by the weighted-average number of the parent's common shares outstanding during the period

While consolidated net income is viewed from an entity perspective, consolidated earnings per share follows a parent company approach and clearly is aimed at the stockholders of the parent company

- Computation of diluted consolidated earnings per share

$$\text{Diluted consolidated EPS} = \frac{\text{Parent's share of consolidated net income} \pm \text{Adjustment for parent securities} - \left(\text{Percent ownership held by parent} \times \text{Income available to common shareholders of subsidiary}\right) + \left(\text{Shares held by parent} \times \text{Subsidiary diluted EPS}\right)}{\text{Weighted average of parent company shares outstanding} + \text{Shares of parent to be issued if dilutive securities are converted and options exercised}}$$

- The parent's share of consolidated net income normally is the starting point in the computation of diluted consolidated EPS
- It then is adjusted for the effects of parent and subsidiary dilutive securities

# THANK YOU