Investments and Acquisitions

- Understand that the accounting method used for investments depends on the extent to which the investor exerts influence over the investee.

- Understand the effects of dividends received and investee income on the financial statements of the investor under the equity method.

- Understand the effects of consolidated accounting on the balance sheet and income statement of the investor.

    - Does an acquisition affect shareholders' equity?
    - What do "minority interest" on the B/S and I/S mean?
    - How is goodwill computed?

Investments in the Stock of Other Companies

- The accounting method for stock investments depends on the degree of influence the investing company has on the decisions of the investee.

- Three methods of accounting for this investment:

Ownership:	<20%	20-50%	>50%
Influence:	"passive"	"significant influence"	"controlling"
Reporting Method:	*Mark-to-market*	*Equity*	*Consolidation*

Significant Influence ➔ Equity Method

- Assume the following events
  1. Purchase: Investor acquires 48,000 shares amounting to 40% of EE Corporation for $10 per share
  2. Dividends: EE Corporation pays a dividend of $60,000 or 50 cents per share
  3. Affiliate earnings: EE Corporation Earns $100,000 in Net Income

- Record these events on BSE of investor company.

	Cash	Long-term Investment	R/E	Comment
1. Purchase	(480,000)	480,000		
2. Dividends	24,000	(24,000)		
3. Aff. earnings		40,000	40,000	Invest. inc

40% × $60,000

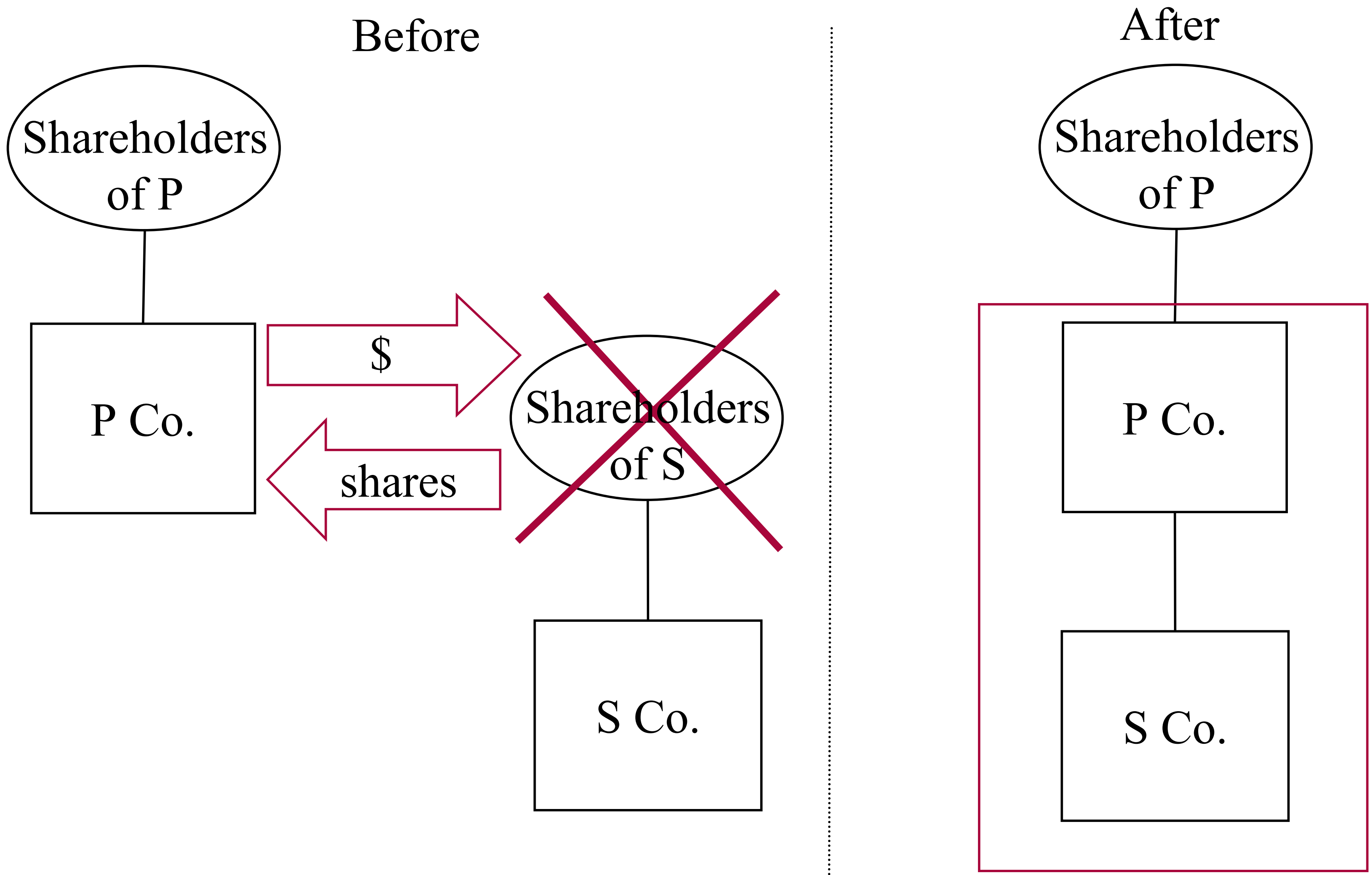
40% × $100,000

Control → Consolidation Method

- When the investor controls the investee,
  - The investor corporation becomes a *parent*.
  - The investee corporation becomes a *subsidiary*.
  - The parent prepares consolidated financial statements that treat the parent and the subsidiary as a single *economic entity* even though they are separate *legal* entities.

- Consolidated financial reporting brings together multiple sets of financial records
  - Each subsidiary maintains its own set of books that are independent of who owns it
  - Parent prepares consolidation financial statements.

Schematic of a 100% Acquisition



➔**Consolidated equity reflects ownership interest of P's shareholders**

Consolidation: <100% Purchase

- Suppose P Co. buys 80% of S Co.'s stock for $88 cash.
  (80% × $110)

➔ Minority interests (economic concept)
  - Investors who own the remaining 20% of S Co. have a claim on the assets and earnings of S Co.
  - But P controls S, so P has access to all of S's assets (not just 80%)
  - P's consolidated reports shows 100% of S's assets and liabilities, then adjusts for the 20% of S not owned by using an account called "Minority Interest".

- Is Minority Interest a liability or equity?
  - Has characteristics of both. It may be classified as either SE or a liability claim of indeterminate amount and life.

Consolidation Method when Price Paid ≠ BV

- We previously assumed that

  BV of S Corp's S. E. = Amount paid for S Corp.

  In practice this is unlikely. What if:

  BV of S Corp's S. E. ≠ Amount paid for S Corp?

- We must first adjust S Corp's balance sheet to produce consolidated books.
  (1) Write-up the identifiable assets of S to their fair market values.
  (2) Record as goodwill any excess of purchase price over the total fair market value of these assets.

- Formally, goodwill is the excess of cost of an acquired firm over the current fair market value of the separately identifiable net assets (assets - liabilities).

Idea Behind Consolidation Adjustments

- Consolidation combines the financial statements of parent and subsidiaries, as if the parent purchased the net assets of the subsidiaries, resulting in one set of F/S.
- But there are numerous items that appear twice.
  - Adjustments correct for the double-counting that would result from simply adding the financial statements together.
  - Some other adjustments we have not addressed:
    - Inter-company receivables and payables
    - Inter-company sales, costs, and profits
    - Tracing the effects of FV adjustments of S's net assets in subsequent years.

Consolidation: Purchase vs. Pooling

- The above examples use the *purchase method* of accounting for acquisitions. Until recently, use of the *pooling method* was required in some cases.
- The pooling method:
  - Combined the company's balance sheets "as is" – no revaluation of subsidiary's assets, no goodwill (i.e., pretend that there was no purchase transaction).
  - Included the incomes of the entities for all prior periods without regard to the date of the combination (i.e., pretend the entities had always been combined).

Everyone out of the pool!

- SFAS 141 eliminated the pooling method. All acquisitions now must use the purchase method.
- Also, SFAS 142 eliminated the requirement to amortize goodwill. Instead, goodwill must be periodically tested for impairment.
- Question: What will happen to the earnings of companies that have goodwill on their balance sheets?

Summary

- Accounting for long-term investments depends on degree of influence as determined by percentage holdings.
- In equity method and consolidation, the investment account:
  - increases when investee earns profits and
  - decreases and when investee pays dividends.
- Consolidation process:
  - Shows the combined F/S of parent and sub, and
  - Removes any double-counting
- Acquirer records goodwill when it pays more than fair value of the investee's net assets.