Accounting for Equity Investments & Acquisitions

% of Outstanding Voting Stock Acquired

0% – 20%	20% – 50%	50% – 100%	
Nominal	Significant	Control	Level of Influence
Fair Value	Equity method	Equity method	Valuation Basis
Investment account	Investment account	Consolidate	Balance Sheet

Equity Method - Introduction

- Records the initial purchase of an investment at acquisition cost
- Each period, the investor captures its proportionate share of the periodic earnings
  - Not the dividends of the investee
- Investor treats dividends declared by the investee
  - Reduction in the investment account.

Equity Method - Rationale

- Why not mark-to-market such investments?
  - Under the market value method for securities available for sale, the investor recognizes income statement effects only when it receives a dividend (revenue) or sells some of the investment (gain or loss).

Example – Equity Method

- 12/31/2003 XYZ Inc. purchases 40% of the outstanding shares of ABC Inc. for $1.2M
  - Book value of ABC = market value at this date ($ 3M)
  - At 2004 ABC reports income of $250,000 and pays dividend of $100,000
  - At 2005 ABC reports earnings of $500,000 and pays dividends of $225,000
- How and in what amount should this investment be presented on XYZ's balance sheet on December 31, 2004 and 2005?

Journal Entries: At the Acquisition Date

Investment in ABC's stock	1,200,000	
Cash		1,200,000

- Record the acquisition of 40% of ABC Inc. 1,200,000=40% x 3,000,000

Year 2004

Investment in ABC stock	100,000	
Equity in Earnings of Affiliate		100,000

- To record XYZ's share in the income earned by ABC

Cash	40,000	
Investment in ABC stock		40,000

- To record dividends received from ABC

Year 2005

Investment in Stock of ABC	200,000	
Equity in Earnings of Affiliate		200,000

- To record XYZ's share in the income earned by ABC

Cash	90,000	
Investment in Stock of ABC		90,000

- To record dividend received from ABC.

Balance Sheet Looks Like...

- Firm XYZ's "Investment in ABC" account now has a balance of $1,370,000 by the end of 2005:

Investment in Stock of ABC

(1) 1,200,000	40,000 (3)
(2) 100,000	90,000 (5)
(4) 200,000	
Balance 1,370,000	

Consolidation Accounting

- In a business combination, one company (***Parent***) gains control over another company (***Subsidiary***)
- Until 2001, two consolidation methods were used for mergers and acquisitions
  - Purchase method
  - Pooling of interests method
    - In 2001, the FASB discontinued the pooling method (Statement 141)

Meaning of Control

- An entity that has the ability to elect a majority of the board of directors of another entity has ***control*** over it
- Control enables the parent:
  - Direct the sub to expand, contract or distribute cash to the parent
  - Establish the sub financing structure
  - Fire and hire the sub management
  - Set compensation level for the sub management.

Means of Control

- ***Legal Control***
  - Owning ***more than*** 50% of the subsidiary's outstanding voting stock
  - Parent has the legal right to elect the majority of the board of directors
- ***Effective Control***
  - Majority of the board of directors can be elected by means other then having legal control.

Three Categories of Combination

- ***Merger***
  - One firm acquires the assets and liabilities of one or more other firms in exchange for cash, stock or other compensation
  - Acquired firm ceases to exist as a separate legal entity
  - 100% ownership

Three Categories of Combination...

- ***Statutory Consolidation***
  - New firm is formed to issue stock in exchange for the stock of the two or more consolidating firms
  - Acquired firms cease to exist as separate legal entities
  - 100% ownership.

Three Categories of Combination...

- ***Acquisition***
  - One firm acquires the majority of the common stock of another company and each company continues its legal existence
  - Each company must be accounted for separately and prepare its own set of financial statements
  - Financial statements are then consolidated

    Consolidated financial statements - combination of the financial statements of the parent company with those of the subs an overall report ***as if*** they were a ***single*** entity

Consolidation Process

- Eliminating worksheet entries are made to reflect the two separate companies' statements as one economic entry
- No consolidation elimination entries are recorded on the books of either the parent or the subsidiary.

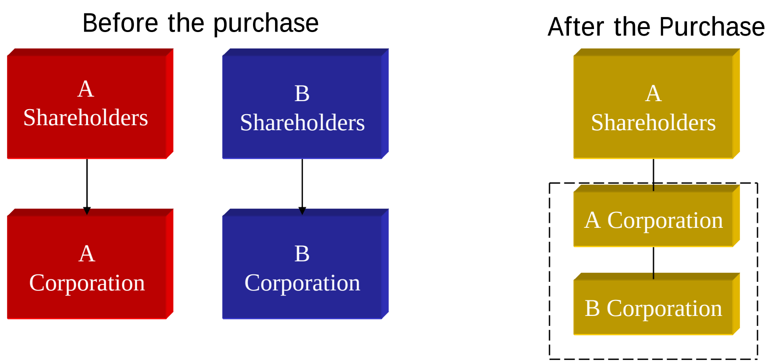
Consolidation - Rationale

- Economically, the parent has the power to liquidate the subsidiary into a branch
  - In this case the current legal structure of two separate companies will cease to exist.
- Thus, the parent and the sub are treated as a single legal entity.

Purchase Method

- Business combinations
  - Use the ***purchase method***
  - Acquisitions are measured on the basis of the ***fair values*** exchanged.

Consolidation: Wholly-Owned Subsidary



Wholly-Owned Subsidiaries

- Parent’s perspective
  - Purchase → exchange of one asset for another, usually cash for the stock of the subsidiary
  - Consolidated net income = parent’s net income.
  - Consolidated retained earnings = parent’s retained earnings
- Sub.’s retained earnings
  - Eliminated in consolidation.

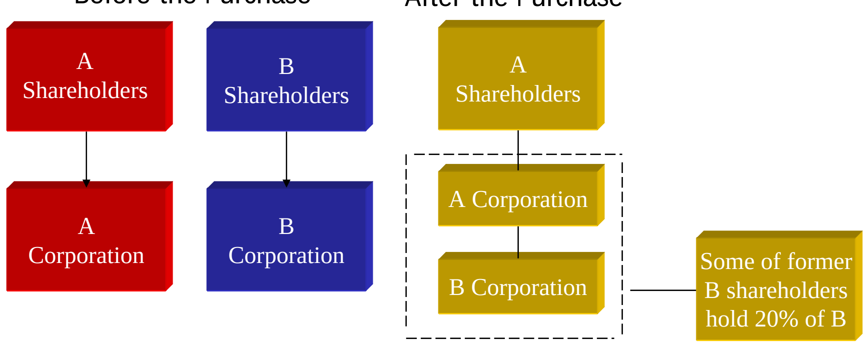
Partially-Owned Subsidiaries

- If parent company owns < 100% of sub
  - Minority interest exists
    - Calculated using book value of acquired firm
    - Balance sheet reflects the rights of non-majority shareholders in the assets and liabilities of a company that is consolidated into the accounts of the major shareholder
      - Appears after long-term debt but before stockholders' equity (quasi liability).
  - Minority income
    - Income statement ➔ reflects the share of non-majority shareholders in the earnings of a the consolidated firm
      - Appears as a line item deduction.

Consolidation – 80% Owned Sub

Before the Purchase

After the Purchase



Purchased Goodwill

- ***Goodwill***
  - Excess of the cost of an acquired company over the sum of the fair market value of its net identifiable individual assets
- Goodwill usually results from one or more of the following:
  - Brand name
  - Good employees
  - Customer loyalty
  - Monopoly power.

Recognition & Measurement of Goodwill

- Dictated by Statement No. 142: Goodwill and Other Intangible Assets (July 20, 2001)
- Goodwill should not be amortized
  - Tested for impairment at a level of reporting referred to as a reporting unit
  - Reporting unit ➔ operating segment or one level below an operating segment
    - A component of an operating segment is a reporting unit if the component constitutes a business for which discrete financial information is available and segment management regularly reviews the operating results of that component
  - Impairment ➔ exists when the carrying amount of goodwill exceeds its implied fair value.

“Negative” Goodwill

- When the fair market value of the assets acquired exceeds the acquisition cost, the excess is first used to reduce the carrying value of noncurrent, nonfinancial assets.
- If such assets are reduced to zero, any additional amount is recognized as extraordinary gain.

Grasping the Intangible

- Article provides a better perspective of goodwill than defined by accountants
- Consistent with the economic concept of economic value added or abnormal profits
- Turn to the article.

Acquisition Costs for R&D

- Using arcane accounting rule to get rid of goodwill
  - Write-off as “purchased R&D”
    - Acquirer sets price of “in-process” R&D assets and immediately writes them off
    - No guidelines on valuation of research
  - Many companies writing off > 50% of acquisition cost
- Problem
  - Overstates ROE since equity written off.

Goodwill: Impairment Test

- Goodwill of a reporting unit should be tested for impairment on ***an annual basis*** and between annual tests in certain circumstances
- Annual goodwill impairment test may be performed any time during the fiscal year provided the test is performed at the same time every year
  - Different reporting units may be tested for impairment at different times.

Impairment Test – Step 1

- Compare the fair value of a reporting unit with its carrying amount, including goodwill
  - Fair value of a reporting unit > carrying amount
    - Goodwill of the reporting unit is not impaired
    - 2nd step of the impairment test is unnecessary
  - Carrying amount of a reporting unit > fair value
    - 2nd step of the goodwill impairment test performed.

Impairment Test – Step 2

- Compares the implied fair value of reporting unit goodwill with the carrying amount of that goodwill
  - Carrying amount of reporting unit goodwill > implied fair value of that goodwill
    - Impairment loss = excess.
    - Loss recognized cannot exceed the carrying amount of goodwill
  - After a goodwill impairment loss is recognized
    - Adjusted carrying amount of goodwill is its new accounting basis
  - Subsequent reversal of a previously recognized goodwill impairment loss is prohibited.

Goodwill Impairment: Triggering Events

- Goodwill of a reporting unit should be tested for impairment ***between annual tests*** if an event occurs or circumstances change that would ***more likely than not*** reduce the fair value of a reporting unit below its carrying amount.

Examples of Triggering Events

- Significant adverse change in legal factors
- Adverse action or assessment by a regulator
- Unanticipated competition
- Loss of key personnel
- More-likely-than-not expectation that a reporting unit or a significant portion of a reporting unit will be sold or otherwise disposed of
- Recognition of a goodwill impairment loss in the financial statements of a subsidiary that is a component of a reporting unit.

Financial Statement Presentation

- Aggregate amount of goodwill
  - Presented as a separate line item in the balance sheet
- Aggregate amount of goodwill impairment losses
  - Presented as a separate line item in the income statement before the subtotal *income from continuing operations* (or similar caption) unless a goodwill impairment loss is associated with a discontinued operation
  - Goodwill impairment loss associated with a discontinued operation should be included (on a net-of-tax basis) within the results of discontinued operations.

Pooling of Interests

- Under APB 16, business combinations were accounted for using one of two methods, the pooling-of-interests method (pooling method) or the purchase method
  - Use of the pooling method was required whenever 12 criteria were met; otherwise, the purchase method was to be used
  - Pooling accounting is no longer allowed.

The End