

FINANCIAL ACCOUNTING & REPORTING

CPA2901US3-37

TABLE OF CONTENTS

About Updating Supplement Version 37.3.....	2
Study Options Available to Candidates.....	2
Other Sources of Information for Candidates.....	2
Recent Announcements.....	3
FASB Accounting Standards Codification.....	3
Recent Pronouncements.....	4
GASB 52, <i>Land and Other Real Estate Held as Investments by Endowments</i>	4
SFAS 141 (revised 2007), <i>Business Combinations</i>	4
SFAS 160, <i>Noncontrolling Interests in Consolidated Financial Statements</i> — <i>an amendment of ARB No. 51</i>	5
SFAS 161, <i>Disclosures About Derivative Instruments and Hedging Activities</i> — <i>an amendment of FASB Statement No. 133</i>	5
SFAS 162, <i>The Hierarchy of Generally Accepted Accounting Principles</i>	6
SFAS 163, <i>Accounting for Financial Guarantee Insurance Contracts</i> — <i>an interpretation of FASB Statement No. 60</i>	6
Errata.....	7
Revisions.....	8

We wish to thank the American Institute of Certified Public Accountants and the Financial Accounting Standards Board for permission to reprint the following copyright © materials:

1. Uniform CPA Examination Questions and Unofficial Answers, Copyright © American Institute of Certified Public Accountants, Inc., Harborside Financial Center, 201 Plaza Three, Jersey City, NJ 07311-3881
2. Accounting Research Bulletins, APB Opinions, APB Statements, and Code of Professional Conduct.
3. FASB Statements, Interpretations, and Statements of Financial Accounting Concepts (SFAC), Copyright © Financial Accounting Standards Board, 401 Merrit 7, P.O. Box 5116, Norwalk, CT 06856, U.S.A. Reprinted with permission. Copies of the complete documents are available from the FASB.
4. Statements on Auditing Standards (SAS), Statements on Standards for Accounting and Review Services (SSARS), Statements on Standards for Accountants' Services on Prospective Financial Information, Statements on Standards for Attestation Engagements (SSAE), and Statements on Quality Control Standards (SQCS).

Copyright © 2008 by Bisk Education, Inc. Tampa, FL 33631-3028
All rights reserved. Reproduction in any form is expressly prohibited.
Printed in the United States of America.

This publication is designed to provide accurate and authoritative information in regard to the subject matter covered. It is sold with the understanding that the publisher is not engaged in rendering legal, accounting or other professional service. If legal advice or other expert assistance is required, the services of a competent professional person should be sought.—
From a Declaration of Principles jointly adopted by a Committee of the American Bar Association and a Committee of Publishers and Associations.

ABOUT UPDATING SUPPLEMENT VERSION 37.3

This supplement is designed to bring the very latest information to candidates using our products in preparation for the CPA exam in the October-November 2008, and later, exam windows. Candidates with the 37th edition CPA Review textbook or the corresponding Version 11 series software will find the information in Updating Supplement Version 37.3 more than adequate for these exam windows.

When new information first becomes available, the examiners tend to test new or changed portions of concepts lightly. Coverage of information after that point may increase, if it is in a heavily tested area. Do not fall into the trap of attaching undue significance to new information merely because it is new.

Accounting and auditing pronouncements are eligible to be tested on the CPA exam in the testing window beginning six months after a pronouncement's *effective* date, unless early application is permitted. When early application is permitted, a new pronouncement may be tested in the window beginning 6 months after the *issuance* date. In this case, *both* the previous and the new pronouncements can be tested until the previous pronouncement has been superseded.

Remember, with the information and techniques in our material, passing the exam is an attainable goal. ***Adhere to a reasonable study plan—and pass the first time!***

STUDY OPTIONS AVAILABLE TO CANDIDATES

As every candidate's needs are different, Bisk Education offers a variety of CPA Review formats and packages that are guaranteed* to help you pass the CPA exam on your next sitting. Options include: our Online CPA Review with structured Internet classes and our self-study CPA Review utilizing multimedia CD-ROM software, video lectures, audio lectures, and books.

**Purchase of software required. Call for complete details. (1-800-404-7231)*

OTHER SOURCES OF INFORMATION FOR CANDIDATES

Candidates choosing to use previous editions of our books must accept responsibility for adequately updating their materials and should consider the strain that this will add to the already time-consuming process of studying for the exam. Candidates with the 35th and earlier editions are strongly encouraged to purchase new materials. Please contact a customer service representative at 1-800-280-9718.

Candidates with the 36th edition CPA Review textbook or corresponding Version 10 series software will also need FAR Updating Supplement Version 36.2. FAR Updating Supplement Version 36.2 contains summaries of GASB 48, 49, 50, 51, and Concept Statement No. 4. It also contains a summary of and information on SFAS 159. (This content is integrated into the 37th edition.)

RECENT ANNOUNCEMENTS

FASB Accounting Standards Codification™

On January 15, 2008, the Financial Accounting Standards Board (FASB) officially launched the one-year verification phase of the *FASB Accounting Standards Codification™* (Codification). During the verification period, constituents are encouraged to use the online Codification Research System free of charge to research accounting issues and provide feedback on whether the Codification content accurately reflects existing U.S. generally accepted accounting principles (GAAP) for nongovernmental entities. Users are advised that the Codification content is not yet approved as authoritative and, therefore, they must verify research results using their existing resources for the currently effective literature.

After addressing the issues raised during the constituent feedback process, the FASB is expected to formally approve the Codification as the single source of authoritative U.S. GAAP, other than guidance issued by the Securities and Exchange Commission (SEC). To improve usability, the Codification will include authoritative content issued by the SEC, as well as selected SEC staff interpretations. Upon approval by the FASB, all accounting standards (other than the SEC guidance) used to populate the Codification will be superseded. At that time, with the exception of any SEC or grandfathered guidance, all other accounting literature not included in the Codification will become nonauthoritative.

Users who register at <http://asc.fasb.org> are able to review the Codification free of charge and provide specific content-related feedback at the individual paragraph level as well as general system-related feedback. During the verification period, Codification content will be updated for changes resulting from constituent feedback and new standards.

The Codification includes all accounting standards issued by a standard-setter within levels A through D of the current U.S. GAAP hierarchy, including FASB, American Institute of Certified Public Accountants (AICPA), Emerging Issues Task Force (EITF), and related literature.

The Codification does not change GAAP; instead it reorganizes the thousands of U.S. GAAP pronouncements into roughly 90 accounting topics, and displays all topics using a consistent structure. The SEC guidance will follow a similar topical structure in separate SEC sections.

The home page of the Codification Research System includes various items that users should be aware of. This includes a Notice to Constituents that describes Codification-related matters, including content matters for constituent feedback. For example, the Notice addresses the standards and elevated guidance used to populate the Codification, the use of December 31, 2008, as the authoring effective date, and conflicts resolved by Board decision for which the Board is requesting feedback.

The Codification Research System also includes general information about how to use the online research system and special features such as *Cross Reference Reports* (to locate where standards reside), *Join Sections* (to join similar Sections from multiple Topics and Subtopics into a single document), and *Go To* (to jump directly to a specific Topic, Subtopic, Section, or paragraph). The Accounting Standards Codification excludes governmental accounting standards.

Editor's Note:

This announcement states there is a one year verification phase. The FASB will not approve the codification until after they've addressed the issues raised during this feedback process. As such, the effects of this codification will not be testable on the CPA exam until 6 months after that approval. The FASB expects to release the codification as authoritative in July 2009. The AICPA expects this research system will first be used in the October-November 2010 exam window.

RECENT PRONOUNCEMENTS

GASB 52, *Land and Other Real Estate Held as Investments by Endowments* (Issued 11/07)

This statement is eligible to be tested beginning in the April-May 2009 exam window.

In November 2007, the GASB issued Statement of Governmental Accounting Standard No. 52, *Land and Other Real Estate Held as Investments by Endowments*. This Statement amends GASB Statement 31, Paragraph 2.

This Statement establishes consistent standards for the reporting of land and other real estate held as investments by essentially similar entities. It requires endowments to report their land and other real estate investments at fair value. Governments also are required to report the changes in fair value as investment income and to disclose the methods and significant assumptions employed to determine fair value, and other information that they currently present for other investments reported at fair value.

This Statement more appropriately reports the resources available in endowments and more closely aligns financial reporting with the objectives of endowments. It results in property held for similar purposes by comparable entities being reported in the same manner. Reporting land and other real estate held as investments at fair value enhances users' ability to meaningfully evaluate an entity's investment decisions and performance.

The requirements of this Statement are effective for financial statements for periods beginning after June 15, 2008.

SFAS 141 (revised 2007), *Business Combinations* (Issued 12/07)

This statement is eligible to be tested beginning in the July-August 2009 exam window.

In December 2007, the FASB issued Statement of Financial Accounting Standards No. 141 (revised 2007), *Business Combinations*. This Statement replaces FASB Statement No. 141, *Business Combinations*. This Statement also makes significant amendments to other Statements and other authoritative guidance.

The objective of this Statement is to improve the relevance, representational representativeness, and comparability of the information that a reporting entity provides in its financial reports about a business combination and its effects. To accomplish that, this Statement establishes principles and requirements for how the acquirer:

- a. Recognizes and measures in its financial statements the identifiable assets acquired, the liabilities assumed, and any noncontrolling interest in the acquiree
- b. Recognizes and measures the goodwill acquired in the business combination or a gain from a bargain purchase
- c. Determines what information to disclose to enable users of the financial statements to evaluate the nature and financial effects of the business combination

This Statement applies prospectively to business combinations for which the acquisition date is on or beginning of the first annual reporting period beginning on or after December 15, 2008. An entity may not apply it before that date. The effective date of this Statement is the same as that of the related FASB Statement No. 160, *Noncontrolling Interests in Consolidated Financial Statements*.

Note: Because early application is *not* permitted, this statement will not be eligible to be tested until the July-August 2009 exam window.

SFAS 160, *Noncontrolling Interests in Consolidated Financial Statements—an amendment of ARB No. 51* (Issued 12/07)

This statement is eligible to be tested beginning in the July-August 2009 exam window.

In December 2007, the FASB issued Statement of Financial Accounting Standards No. 160, *Noncontrolling Interests in Consolidated Financial Statements*. This Statement amends ARB 51 to establish accounting and reporting standards for the noncontrolling interest in a subsidiary and for the deconsolidation of a subsidiary. It also amends certain of ARB 51's consolidation procedures for consistency with the requirements of FASB Statement No. 141 (revised 2007), *Business Combinations*. Appendix A includes the amendments to ARB 51.

The objective of this Statement is to improve the relevance, comparability, and transparency of the financial information that a reporting entity provides in its consolidated financial statements by establishing accounting and reporting standards for the noncontrolling interest in a subsidiary and for the deconsolidation of a subsidiary.

This Statement shall be effective for fiscal years, and interim periods within those fiscal years, beginning on or after December 15, 2008. Earlier adoption is prohibited. This Statement shall be applied prospectively as of the beginning of the fiscal year in which this Statement is initially adopted, except for the presentation and disclosure requirements.

Note: Because early application is prohibited, this statement will not be eligible to be tested until the July-August 2009 exam window.

SFAS 161, *Disclosures about Derivative Instruments and Hedging Activities* (Issued 03/08)

This statement is eligible to be tested beginning in the October-November 2008 exam window.

In March 2008, the FASB issued Statement of Financial Accounting Standard No. 161, *Disclosures about Derivative Instruments and Hedging Activities—an amendment of FASB Statement No. 133*. This Statement amends and expands the disclosure requirements of Statement 133. This Statement requires qualitative disclosures about objectives and strategies for using derivatives, quantitative disclosures about fair value amounts of and gains and losses on derivative instruments, and disclosures about credit-risk-related contingent features in derivative arguments.

This objective of this Statement is to provide users of financial statements with an enhanced understanding of (a) how and why and entity uses derivative instruments, (b) how derivative instruments and related hedge items are accounted for under Statement 133 and its related interpretations, and (c) how derivative instruments and related hedge items affect an entity's financial position, financial performance, and cash flows.

This Statement is effective for financial statements issued for fiscal years and interim periods beginning after November 15, 2008, with early application encouraged. This Statement encourages, but does not require, comparative disclosures for earlier periods at initial adoption.

Note: The editors do not expect the material in this Statement to be heavily tested.

SFAS 162, *The Hierarchy of Generally Accepted Accounting Principles* (Issued 05/08)

In May 2008, the FASB issued Statement of Financial Accounting Standard No. 162, *The Hierarchy of Generally Accepted Accounting Principles*. This Statement identifies the sources of accounting principles and the framework for selecting the principles used in the preparation of financial statements of nongovernmental entities that are presented in conformity with generally accepted accounting principles (GAAP) in the United States (the GAAP hierarchy).

This Statement applies to financial statements of nongovernmental entities that are presented in conformity with GAAP.

Any effect of applying the provisions of this Statement shall be reported as a change in accounting principle in accordance with FASB Statement No. 154, *Accounting Changes and Error Corrections*. An entity shall follow the disclosure requirements of that Statement, and additionally, disclose the accounting principles that were used before and after the application of the provisions of this Statement and the reason why applying this Statement resulted in a change in accounting principle.

This Statement shall be effective 60 days following the SEC's approval of the Public Company Accounting Oversight Board (PCAOB) amendments to AU Section 411, *The Meaning of Present Fairly in Conformity With Generally Accepted Accounting Principles*.

Note: The SEC approved the PCAOB amendments to AU Section 411 on September 16, 2008 thus making this statement eligible to be tested beginning in the **April-May 2009** exam window.

SFAS 163, *Accounting for Financial Guarantee Insurance Contracts* (Issued 05/08)

The bulk of this statement is eligible to be tested beginning in the July-August 2009 exam window.

In May 2008, the FASB issued Statement of Financial Accounting Standard No. 163, *Accounting for Financial Guarantee Insurance Contracts—an interpretation of FASB Statement No. 60*. This Statement requires that an insurance enterprise recognize a claim liability prior to an event of default (insured event) when there is evidence that credit deterioration has occurred in an insured financial obligation. This Statement also clarifies how Statement 60 applies to financial guarantee insurance contracts, including the recognition and measurement to be used to account for premium revenue and claim liabilities. This Statement also requires expanded disclosures about financial guarantee insurance contracts.

The objective of this Statement is to clarify how Statement 60 applies to financial guarantee contracts and in doing such increase comparability in financial reporting of financial guarantee insurance contracts by insurance enterprises. The accounting and disclosure requirements of the Statement will improve the quality of information provided to users of financial statements.

This Statement is effective for financial statements issued for fiscal years beginning after December 15, 2008, and interim periods within those fiscal years. However, the disclosure requirements in paragraphs 30(g) and 31 are effective for the first period (including interim periods) beginning after issuance of this Statement. Except for the disclosures effective for the first period (including interim periods) beginning after issuance of this Statement, earlier application is not permitted.

Note: The editors do not expect the material in this Statement to be heavily tested.

ERRATA

The following items are in the textbook only, unless otherwise noted. If you find other items that you believe are ambiguous or in error, please contact the Bisk Education editors (editor@cpaexam.com) with details.

- Chapter 1: Page 1-29, Question 25 (8074). The correct answer is d, but the explanation is incorrect. The explanation should read “The FASB Statements of Financial Accounting Standards are in the top tier of the GAAP hierarchy and therefore most authoritative. The AICPA Statements of Position and Industry Audit and Accounting Guides are in the second tier, if cleared by the FASB, else in the fourth tier of the GAAP hierarchy. FASB Statements of Accounting Concepts are in the bottom GAAP hierarchy tier and therefore the least authoritative.” instead of what is listed.
- Chapter 2: Page 2-33, Example 16, Solution. The total amount of the calculation and corresponding entry amounts should read “3,700” instead of “3,750”.
- Chapter 4: Page 4-8, Example 4, Solutions. The formula for Note (6) should read “[BV of new asset + cash received] – BV of old asset = gain (loss) on exchange;” instead of “[BV of old asset + cash received] – BV of new asset = gain (loss) on exchange;”.
- Page 4-26, Problem 4-4, Gain/Loss tab. Row 11-Column B should read “24,500” instead of “25,500”.
- Page 4-38, Solution 4-4, Gain/Loss tab. Row 11-Column B. should read “24,500” instead of “25,500”.
- Chapter 6: Page 6-3, Example 3 ▶ Interest Income & Discount Amortization, Solution. The “Interest Income” line for items (1) and (2) should be indented to indicate a credit journal entry.
- Chapter 10: Page 10-28, Example 20 ▶ Lump-Sum Distribution, Solution. The last column, under Capital, of the first Balances line should read “22,400” instead of “22,000”.
- Page 10-59, Solution 10-3, Balance Sheet tab. Item [2] should read “1,855,000” instead of “1,860,000” and its explanation should read as follows:
 “Additional paid-in capital: 1,600,000 + 255,000 = 1,855,000
- | | | |
|--|---------|------------------------------|
| Cash (20,000 shares × \$16) | 320,000 | (320,000 instead of 325,000) |
| Stock Options Outstanding | 35,000 | |
| Common Stock (20,000 × \$5) | 100,000 | |
| Add'l Paid-in Cap., Common
(to balance) | 255,000 | (255,000 instead of 260,000) |
- To record the exercise of options.”
- Item [6] should read “4,780,000” instead of “4,785,000” and its explanation should read “\$900,000 + 1,855,000 + 2,025,000 = \$4,780,000”.
- Item [8] should read “4,730,000” instead of “4,735,000” and its explanation should read “Total stockholders equity \$4,780,000 – 50,000 = \$4,730,000”.
- Chapter 11: Page 11-59, “Problem” 11-2 should read as “Solution” 11-2.

REVISIONS

The following items are revisions to the text to either better clarify information or update the information because of changes in accounting standards. Please ensure you annotate your study material accordingly.

Chapter 1: Page 1-21. Replace section VII.B titled “GAAP Hierarchy” with the following:

B. GAAP Hierarchy

SFAS 162 replaced SAS 69 as the authority in establishing the sources of accounting principles and the framework for selecting the principles to be used in the preparation of financial statements of nongovernmental entities that are presented in conformity with generally accepted accounting principles (GAAP) in the United States (the GAAP hierarchy). The hierarchy is shown in Exhibit 7.

Exhibit 7 ▶ GAAP Hierarchy

1. FASB Statements of Financial Accounting Standards and Interpretations, FASB Statement 133 Implementation Issues, FASB Staff Positions, AICPA Accounting Research Bulletins, and APB Opinions that are not superseded by actions of the FASB
2. FASB Technical Bulletins and, if cleared by the FASB, AICPA Industry Audit and Accounting Guides and Statements of Position
3. AICPA Accounting Standards Executive Committee (AcSEC) Practice Bulletins that have been cleared by the FASB, consensus positions of the FASB EITF, and the Topics discussed in Appendix D of *EITF Abstracts* (EITF D-Topics)
4. Implementation guides (Q&As) published by the FASB staff, AICPA Accounting Interpretations, AICPA Industry Audit and Accounting Guides and Statements of Position not cleared by the FASB, and practices that are widely recognized and prevalent either generally or in the industry
5. Accounting principles for similar transactions or events within the above categories and then other accounting literature. Other accounting literature includes, for example, FASB Concepts Statements, AICPA Issues Papers, International Financial Reporting Standards (IFRSs) of the International Accounting Standards Board (IASB), ; pronouncements of other professional associations or regulatory agencies, Technical Information Service Inquiries and Replies included in AICPA Technical Practice Aids, and accounting textbooks, handbooks, and articles.

Chapter 2: Pages 2-11 through 2-14. Replace section IV titled “Investments in Marketable Securities (SFAS 115)” with the following:

A. Applicability

SFAS 115 applies to investments in equity securities that have a readily determinable fair value and to all investments in debt securities. SFAS 115 does **not** apply to investments in equity securities that, absent the election of the fair value option under SFAS 159, *The Fair Value Option for Financial Assets and Financial Liabilities*, would be required to be accounted for under the equity method nor to investments in consolidated subsidiaries. The focus of guidance in SFAS 115 is on portfolios (groups of stocks) rather than individual stocks.

B. Classification

Securities are classified in one of three categories: held-to-maturity (HTM) securities, trading securities, or available-for-sale (AFS) securities.

1. **Held-to-Maturity (HTM) Securities** Debt securities that the enterprise has the positive intent and the ability to hold to maturity.
 - a. Reported at amortized cost, though fair value must be disclosed.
 - b. Not adjusted for unrealized holding gains and losses.

- c. If the fair value option is elected, cumulative unrealized gains and losses at the effective date shall be included in the cumulative effect adjustment. The amount of unrealized gains and losses previously unrecognized shall be separately disclosed.
2. **Trading Securities** Debt and equity securities that are bought and held principally for the purpose of selling them in the near term to generate profits on short-term differences in price.
- a. Reported at fair value, if readily determinable.
- b. Unrealized holding gains and losses are included in current earnings.
3. **Available-for-Sale (AFS) Securities** Debt and equity securities not classified as either held-to-maturity or trading securities.
- a. Reported at fair value, if readily determinable.
- b. Unrealized holding gains and losses are excluded from current earnings and are instead reported in other comprehensive income (OCI).
- c. If the fair value option is elected, cumulative unrealized gains and losses at the effective date shall be included in the cumulative effect adjustment. The amount of unrealized gains and losses reclassified from accumulated OCI shall be separately disclosed.
- C. Acquisition Cost**
Marketable debt and equity securities are recorded at cost, which includes the purchase price and other direct costs of acquisition, such as broker's fees and taxes. For debt securities purchased between interest dates, accrued interest is **not** part of the cost of the securities. Generally, the discount or premium on temporary investments in debt securities is not recorded separately in the accounts and not amortized because the investment is ordinarily held for only a short time and hence any amortized amount would be immaterial.
- D. Year-End Valuation**
HTM securities are reported at amortized cost. Trading securities and AFS securities are accounted for at fair value, determined at the balance sheet date. For trading securities, the excess of cost over fair value or fair value over cost is recorded directly against the investment account. The offsetting unrealized holding gain or loss shall be included in earnings on the income statement. The excess of cost over fair value or fair value over cost for AFS securities is recorded as a credit or debit in a Market Adjustment account. The offsetting unrealized gain or loss shall be excluded from earnings and be reported in an Other Comprehensive Income (OCI) account until realized.

Example 5 ▶ Available-for-Sale Portfolio, Unrealized Gain

The aggregate cost and fair value (FV) of Zeta Corp.'s investments (all classified as available-for-sale and first purchased in year 1) in marketable securities at 12/31 for years 1 and 2 are given below.

	December 31, Year 1		December 31, Year 2	
	Cost	FV	Cost	FV
Security W	\$ 800	\$1,300	\$ 800	\$1,100
Security X	800	1,000	800	700
Security Y	900	600	1,000*	900
Security Z	900	600	1,000*	1,400
	<u>\$3,400</u>	<u>\$3,500</u>	<u>\$3,600</u>	<u>\$4,100</u>

*Increases reflect net acquisitions during the period.

Required: Determine the following:

- a. Amount to report for these investments on the 12/31, year 1 balance sheet.
- b. Amount of unrealized gain or loss to be recognized in year 2.
- c. Amount to report for these investments on the 12/31, year 2 balance sheet.

Solution:

- a. The fair value of the securities at 12/31, year 1 (\$3,500) is greater than its aggregate cost (\$3,400). Therefore, the Market Adjustment—AFS account would have a \$100 debit balance at 12/31, year 1 and the Unrealized Holding Gain or Loss (OCI) account would have a \$100 credit balance at 12/31, year 1. The securities portfolio is presented in the asset section of the 12/31, year 1 balance sheet.

Investment in securities at fair value	\$3,500
--	---------

- b. At the end of year 2, the fair value of the portfolio (\$4,100) is \$500 greater than its aggregate cost (\$3,600). An additional \$400 debit is required to bring the year-end balance in the valuation account to \$500, resulting in the following journal entry:

Market Adjustment—AFS	400	
Unrealized Holding Gain or Loss (OCI)		400

This brings the Market Adjustment—AFS account balance up to the \$500 (\$4,100 – \$3,600) difference between cost and fair value at year end. Since it pertains to the AFS portfolio, the net unrealized holding gain of \$500 is reported in Accumulated Other Comprehensive Income.

- c. The securities portfolio is presented in the asset section of the 12/31, year 2 balance sheet.

Investment in securities at fair value	\$4,100
--	---------

NOTE: If the securities are classified as current, they would appear in the current asset section of the balance sheet. If they are classified as noncurrent, they would appear in the long-term investment section.

Example 6 ▶ Available-for-Sale Portfolio, Unrealized Loss

Assume the fair value of the portfolio at 12/31, year 1 in Example 5 was \$3,100 rather than \$3,500 (\$300 less than its aggregate cost). Therefore, the Market Adjustment—AFS account would have a \$300 credit balance at 12/31, year 1 and the Unrealized Holding Gain or Loss (OCI) account would have a \$300 debit balance at 12/31, year 1.

At 12/31, year 2, assume the fair value of the portfolio was \$3,500 (only \$100 less than its \$3,600 aggregate cost). Therefore, the Market Adjustment—AFS account must be reduced by \$200 with a corresponding reduction of the balance in the Unrealized Holding Gain or Loss (OCI) account. The journal entry is as follows:

Market Adjustment—AFS	200	
Unrealized Holding Gain or Loss (OCI)		200

This brings the Market Adjustment—AFS account balance down to the \$100 (\$3,600 – \$3,500) difference between cost and fair value at year end. Because it applies to the AFS category, the net unrealized loss of \$100 is reported in OCI. The security portfolio is presented in the asset section of the 12/31, year 2 balance sheet.

Investment in securities at fair value	\$3,500
--	---------

Example 7 ▶ Trading Securities Portfolio, Unrealized Gain or Loss

With the same facts as Example 5, except now the investments are all classified as trading securities. Now the unrealized holding gains and losses flow through the current income statement, rather than through other comprehensive income.

Required: Determine the following:

- Amount of unrealized gain or loss to be recognized in year 1.
- Amount of unrealized gain or loss to be recognized in year 2.
- Amount to report for these investments on the 12/31, year 1 and year 2 balance sheet.

In Example 5, the unrealized holding gain of \$100 would appear in the year 2 income statement.

- At the end of year 1, the unrealized holding gain of \$100 would appear in the year 2 income statement. The \$3,500 fair value of the portfolio in year 1 is \$100 greater than its \$3,400 aggregate cost. The journal entry is as follows:

Investment in Security W	500	
Investment in Security X	200	
Investment in Security Y		300
Investment in Security Z		300
Unrealized Holding Gain or Loss (Income)		100

- At the end of year 2, the unrealized holding gain of \$400 would appear in the year 2 income statement. The \$4,100 fair value of the portfolio in year 2 is \$400 greater than the total of the \$3,500 year 1 fair value plus \$200 new acquisitions in year 2. The journal entry is as follows:

Investment in Security Y	200	
Investment in Security Z	700	
Investment in Security W		200
Investment in Security X		300
Unrealized Holding Gain or Loss (Income)		400

- The investments would be reported at their fair value in both year 1 and year 2.

NOTE: In this example, both year 1 and year 2 had unrealized holding gains. The method would be the same in a situation that may result in an unrealized holding loss. Compare the current fair value to the book value and the result is either an unrealized holding gain or loss.

E. Other Than Temporary Decline in Fair Value

If the decline in fair value for AFS or HTM securities is determined to be other than temporary, the cost basis of the individual security is written down to fair value that becomes the new cost basis and a realized loss is recognized in current earnings.

- Subsequent Increases** The new cost basis is not changed for subsequent recoveries in fair value. Subsequent increases in fair value of AFS securities are accounted for as unrealized gains by debiting the Market Adjustment account and crediting the Unrealized Holding Gain or Loss (OCI) account.
- Subsequent Decreases** Subsequent decreases in fair value of AFS securities, if not other-than-temporary, are accounted for as unrealized losses by debiting the Unrealized Holding Gain or Loss (OCI) account and crediting the Market Adjustment account.

F. Transfers Between Categories

Securities may be transferred among the three classifications: HTM, trading, and AFS. Reclassification should be rare under the guidelines of SFAS 115.

1. **Transfers From Trading** If a security is transferred from the trading category, any previously recognized unrealized holding gain or loss should not be reversed. Additionally, the security should be transferred at fair value with a gain or loss recognized upon transfer.
2. **Transfers to Trading** If a security is transferred into the trading category, any unrealized holding gain or loss related to this security should be recognized in earnings immediately.
3. **Transfers From HTM to AFS** If a debt security is transferred from HTM to AFS category, any unrealized holding gain or loss related to this security should be recognized in an Other Comprehensive Income account consistent with the treatment for AFS securities.
4. **Transfers From AFS to HTM** If a debt security is transferred from AFS to HTM category, any unrealized holding gain or loss related to this security should still be reported in an Other Comprehensive Income account and amortized over the security's remaining life.

G. Sale

The realized gain or loss from the sale of a debt or equity security is the difference between the net proceeds received from the sale (i.e., the gross selling price of the security less brokerage commissions and taxes) and the cost or unamortized cost of the security, or in the case of trading securities its fair value at the most recent balance sheet date.

1. **Previously Recognized Losses or Recoveries** In determining the realized gain or loss on the sale of available-for sale securities, no regard is given to previously recognized unrealized losses or recoveries or to the amount accumulated in the Market Adjustment account.
2. **Reclassification Adjustments** Reclassification adjustments are made to avoid double counting in comprehensive income gains or losses realized and included in net income of the current period that were previously included in other comprehensive income as unrealized gains or losses. Reclassification adjustments for unrealized gains and losses on certain investments in debt and equity securities may be summarized on the face of the financial statement in which comprehensive income is reported or disclosed in the notes to the financial statements.

Exhibit 3 ▶ SFAS 115 Summary

	<u>Trading</u>	<u>Available-for-Sale</u>	<u>Held-to-Maturity</u>
Type of security	Debt or Equity	Debt or Equity	Debt
Accounting at acquisition	Cost (purchase price plus other direct costs of acquisition)	Cost (purchase price plus other direct costs of acquisition)	Cost (purchase price plus other direct costs of acquisition)
End-of-year valuation	Fair value	Fair value	Amortized cost
Valuation adjustments	Adjust investment account	Market adjustment account	Not adjusted for fair value
Change in fair value	Reported in income	Reported in OCI	Not applicable
Other than temporary declines in fair value below cost	Reported in income	Reported in income	Reported in income
Balance sheet classification	Current asset	Either current or non-current asset	Noncurrent asset (Unless maturing within one year)
Dividends and interest earned	Reported in income using interest method to amortize associated premium or discount*	Reported in income using interest method to amortize associated premium or discount	Reported in income using interest method to amortize associated premium or discount

* Generally, the amount of amortization for short-term investments is immaterial and therefore not recorded.

Chapter 2: Pages 2-15 through 2-16. Change the title of section V.A from “Definitions” to “Definitions and Disclosures” and add item 9 to the end of the section as follows:

- 9. Disclosures (SFAS 107)** The following disclosures are required for financial instruments:
- a. Fair Value** An entity must disclose, either in the body of the financial statements or in the accompanying notes, the fair value of financial instruments for which it is practicable to estimate that value and the method(s) and significant assumptions used to estimate the fair value of financial instruments. Practicable means that an estimate of fair value can be made without incurring excessive costs. If it is not practicable to estimate the fair value of a financial instrument or a class of financial instruments, then information pertinent to estimating the fair value of that financial instrument or class of financial instruments, such as the carrying amount, effective interest rate, and maturity along with the reasons why it is not practicable to estimate fair value should be disclosed.
 - b. Concentration of Credit Risk** An entity must disclose all significant concentrations of credit risk arising from **all** financial instruments, whether from an individual counterparty or groups of counterparties. Credit risk is the possibility that a loss may occur from the failure of another party to perform according to the terms of a contract.
 - (1) Group Concentrations** Group concentrations of credit risk exist if a number of counterparties are engaged in similar activities and have similar economic characteristics that would cause their ability to meet contractual obligations to be similarly affected by changes in economic or other conditions.
 - (2) Significant Concentrations** For each significant concentration, disclosure must be made as follows:
 - (a)** Information about the (shared) activity, region, or economic characteristic that identifies the concentration.
 - (b)** The maximum amount of loss exposure due to credit risk if all parties to the financial instruments failed completely to perform and the amounts due proved to be of no value to the entity.
 - (c)** The entity’s policy of requiring collateral or other security to support financial instruments subject to credit risk, information about the entity’s access to that collateral or security, and the nature and a brief description of the collateral or other security.
 - (d)** The entity’s policy of entering into master netting arrangements to mitigate the credit risk and information about such arrangements and the extent the arrangements reduce the credit risk.
 - c. Market Risk** An entity is encouraged, but not required to disclose quantitative information about the market risks of financial instruments that is consistent with the way it manages or adjusts those risks. Market risk is the possibility that future changes in market prices may make a financial instrument less valuable or more onerous.
 - d. Exclusions** Disclosures is not required for employers’ and plans’ obligations for pension benefits, other postretirement benefits, postemployment benefits, employee stock option and stock purchase plans, substantively extinguished debt, insurance contracts, lease contracts, warranty obligations and rights, unconditional purchase obligations, investments accounted for under the equity method, minority interests and equity investments in consolidated subsidiaries, and equity instruments issued by the entity and classified in stockholders’ equity in the statement of financial position.

Chapter 2: Pages 2-20 through 2-21. Replace section V.B.5 titled “Disclosures” with the following:

5. **Disclosures** An entity with derivative instruments shall disclose information to enable users to understand how and why an entity uses derivative instruments, how derivative instruments and related hedged items are accounted for, and how derivative instruments and related hedged items affect an entity’s financial position, financial performance, and cash flows. An entity that holds or issues derivative instruments will disclose the following for every annual and interim reporting period for which a statement of financial position and statement of financial performance are presented:
 - a. **Objectives** Its objectives for holding or issuing those instruments, the context needed to understand those objectives, and its strategies for achieving those objectives. Information about those instruments shall be disclosed in the context of each instrument’s primary underlying risk exposure.
 - b. **Description** Whether the instruments are used for risk management purposes or for other purposes. Derivative instruments used for risk management purposes include those designated as hedging instruments. For hedging instruments the description shall distinguish between fair value hedging instruments, cash flow hedging instruments, and hedging instruments of the foreign currency exposure in a net investment in a foreign operation. For those instruments not designated as hedging instruments the description shall indicate the purpose of the derivative activity.
 - c. **Volume** Information that would enable users of financial statements to understand the volume of its derivative activity. Entities shall select the format and the specifics of disclosures relating to their volume of activity that are most relevant and practicable for their individual facts and circumstances.
 - d. **Hedging Instruments** For hedging instruments, the location and fair value amounts reported in the statement of financial position. The disclosure shall identify the line item(s) of the fair value amounts and the fair value amounts shall be presented on a gross basis as separate asset and liability values. Also, the location and fair value amounts reported in the statement of financial performance is disclosed. The disclosure shall identify the line item(s) of fair value hedges and the effective portion of gains and losses in cash flow hedges separately by type of derivative contract.
 - e. **Fair Value Hedges** For fair value hedges, the net gain or loss recognized in earnings during the reporting period representing the amount of the hedges’ ineffectiveness and the component of the derivative instruments’ gain or loss, if any, excluded from the assessment of hedge effectiveness. Also, the amount of net gain or loss recognized in earnings when a hedged firm commitment no longer qualifies as a fair value hedge.
 - f. **Cash Flow Hedges** For cash flow hedges, a description of the transactions or other events that will result in the reclassification into earnings of gains and losses reported in accumulated OCI, and the estimated net amount of the existing gains or losses at the reporting date expected to be reclassified into earnings within the next 12 months. Also, the maximum length of time over which the entity is hedging its exposure to the variability in future cash flows for forecasted transactions and the amount of gains and losses reclassified into earnings as a result of the discontinuance of cash flow hedges because it is probable that the original forecasted transactions will not occur.
 - g. **Other Comprehensive Income (OCI)** The net gain or loss on derivative instruments designated and qualifying as cash flow hedging instruments that are reported in comprehensive income as a separate classification within other comprehensive income.
 - h. **Accumulated OCI** As part of the accumulated OCI, the beginning and ending accumulated derivative gain or loss, the related net change associated with current period hedging transactions, and the net amount of any reclassification into earnings.

Chapter 2: Pages 2-23 through 2-24. Delete section V.C titled “Disclosures (SFAS 107)” and reorganize so that now section V.D titled “Transfers & Servicing of Financial Assets & Extinguishments of Liabilities (SFAS 140 & 156)” is section V.C in the chapter.

Chapter 5: Page 5-3. Insert 2 lines under section I.C. titled “After Acquisition” and replace section I.C.1 titled “Finite Useful Life” with the following:

C. After Acquisition

Accounting for a recognized intangible asset is based on its useful life. An intangible asset with a finite useful life is amortized; an intangible with an indefinite useful life is not amortized.

1. **Finite Useful Life** Intangible assets with finite useful lives are amortized over their useful lives. The useful life is the period over which the asset is expected to contribute directly or indirectly to future cash flows.
 - a. **Useful Life Estimate** The estimate of the useful life should take into consideration the following pertinent factors, with no one factor being more presumptive than any other:
 - (1) The expected use of the asset by the entity.
 - (2) The expected useful life of another asset or group of assets to which the useful life of the intangible asset may relate.
 - (3) Any legal, regulatory, or contractual provisions that may limit the useful life.
 - (4) The entity’s own historical experience in renewing or extending similar arrangements. In the absence of that experience, the assumptions that market participants would use about extension or renewal.
 - (5) The effects of obsolescence, demand, competition and other economic factors.
 - (6) The level of maintenance expenditures required to obtain the expected future cash flows from the asset.
 - b. **Amortization** An intangible asset shall be amortized over the best estimate of its useful life. The method of amortization should reflect the pattern in which the economic benefits are consumed or used up. If that pattern cannot be reliably determined, a straight-line amortization shall be used.
 - c. **Fair Value** It is common for an income approach to be used to measure the fair value of an intangible asset. In determining the useful life for amortization purposes, an entity shall consider the period of expected cash flows used to measure the fair value of the intangible asset adjusted as appropriate for the entity-specific factors above.
 - d. **Residual Value** The amount of an intangible asset to be amortized shall be the amount initially assigned to the asset less any residual value.
 - e. **Reevaluation** Each reporting period, the remaining useful life should be evaluated to determine whether events and circumstances warrant a revision to the remaining period of amortization.
 - (1) If the remaining useful life changes, the remaining amount of the intangible asset should be amortized prospectively over the revised remaining useful life.
 - (2) If the remaining useful life is indefinite, the asset is no longer amortized and is tested for impairment annually.

Chapter 5: Page 5-5. Replace section I.D.2 titled "Disclosures" with the following:

2. Disclosures

a. Acquisition Period

- (1) Intangible Assets Subject to Amortization** In total and by major intangible asset class; the total amount, the amount of any significant residual value, and the weighted-average amortization period.
- (2) Intangible Assets Not Subject to Amortization** The total amount assigned and the amount assigned to any major intangible asset class.
- (3) Intangible Assets With Renewal or Extension Terms** The weighted-average period prior to the next renewal or extension by major intangible asset class.
- (4) Other Information** The amount of research and development assets acquired, other than a business combination, and written off in the period and the line item in the income statement in which the amounts written off are aggregated.

b. Subsequent Periods

- (1) Intangible Assets Subject to Amortization** The gross carrying amount and accumulated amortization, in total and by major intangible asset class, the aggregate amortization expense for the period, and the estimated aggregate amortization expense for each of the five succeeding fiscal years.
- (2) Intangible Assets Not Subject to Amortization** The total carrying amount and the carrying amount for each major intangible asset class.
- (3) Renewal or Extension Policy** The entity's accounting policy on the treatment of costs incurred to renew or extend the term of a recognizable intangible asset.
- (4) Intangible Assets Renewed or Extended in the Period** The weighted-average period prior to the next renewal or extension by major intangible class and for entities that capitalize renewal or extension costs, the total amount of costs incurred in the period to renew or extend the term of a recognized intangible asset, by major intangible asset class.
- (5) Goodwill** In total and for each reportable segment, the changes in the carrying amount of goodwill during the period showing separately:
 - (a)** The gross amount and accumulated impairment losses at the beginning of the period
 - (b)** Additional goodwill recognized during the period
 - (c)** Adjustments resulting from the subsequent recognition of deferred tax assets during the period
 - (d)** Goodwill included in a disposal group classified as held for sale and goodwill derecognized during the period without having previously been reported in a disposal group classified as held for sale
 - (e)** Impairment losses recognized during the period
 - (f)** Net exchange differences arising during the period due to any foreign currency translation

- (g) Any other changes in the carrying amounts during the period
- (h) The gross amount and accumulated impairment losses at the end of the period

- c. **Periods When Impairment Loss is Recognized** The disclosures for periods that impairment loss is recognized include descriptions of the impaired asset, the facts and circumstances leading to the impairment, the amount of the impairment loss and the method for determining fair value, the caption in the income statement that includes the impairment loss, and any other potentially significant information.

Chapter 9: Pages 9-11 and 9-14. Delete section II.C titled “Recognition of Liabilities & Assets Prior to SFAS 158” and reorganize so that now section II.D titled “Recognition of Liabilities & Assets Following Adoption of SFAS 158” is section II.C in the chapter with a title of “Recognition of Liabilities & Assets” and section II.E titled “Measurement of Plan Assets” is section II.D in the chapter.

Chapter 11: Pages 11-12 through 11-16. Replace sections IV.A, IV.C, and IV.D. under the title heading “Additional Reporting Considerations” with the following, accordingly:

A. Changes in Accounting Principle

A change in accounting principle results from the adoption of a generally accepted accounting principle (GAAP) different from the GAAP previously used for reporting purposes. The term “accounting principle” includes not only accounting principles but also the methods of applying them. Adoption of a principle to record transactions for the first time or to record the effects of transactions that were previously immaterial is not a change in accounting principle. Neither is adoption or modification of an accounting principle brought about by transactions or events that are clearly different than those previously occurring.

1. **Justification** Once an accounting principle is adopted, it shall be used consistently in accounting for similar events and transactions. An entity may change an accounting principle only if:
 - a. The change is required by a newly issued accounting pronouncement, or
 - b. The entity can justify the use of an allowable alternative accounting principle on the basis it is preferable.
2. **Examples** Changes in accounting principle include the following.
 - a. A change in the method of inventory pricing, such as from LIFO to FIFO
 - b. A change in the method of accounting for long-term construction contracts, such as from the completed contract method to the percentage of completion method
3. **Reporting** A change in accounting principle is reported through retrospective application of the new accounting principle to all prior periods, unless it is impracticable to do so. Retrospective application requires the following:
 - a. The cumulative effect of the change to the new accounting principle on periods prior to those presented shall be reflected in the carrying amounts of assets and liabilities as of the beginning of the first period presented or earliest period to which the new accounting principle can be applied.
 - b. An offsetting adjustment, if needed, shall be made to the opening balance of retained earnings for that period.
 - c. Financial statements for each individual prior period presented shall be adjusted to reflect the period-specific effects of applying the new principle.

- d. Only the direct effects of a change in accounting principle are included in retrospective application, including any related income tax effects.
4. **Impracticability** If it is impracticable to determine the cumulative effect of applying a change in accounting principle to any prior period, the new accounting principle shall be applied as if the change was made prospectively as of the earliest date possible. It shall be deemed impracticable to apply the effects of a change in accounting principle only if any of the following conditions exist:
- a. After making every reasonable effort to do so, the entity is unable to apply the requirement.
 - b. Retrospective application requires assumptions about management's intent in a prior period that cannot be independently substantiated.
 - c. Retrospective application requires significant estimates of amounts, and it is impossible to distinguish objectively information about those estimates.
5. **Disclosures in the Fiscal Period in Which a Change in Accounting Principle is Made:**
- a. The nature and reason for the change in accounting principle and the method of applying the change.
 - b. A description of the prior-period information that has been retrospectively adjusted, if any.
 - c. The effect of the change on income before extraordinary items, net income, and the related per share amounts for all periods presented, either on the face of the income statement or in the notes thereto.
 - d. The cumulative effect of the change on retained earnings or other components of equity or net assets in the statement of financial position as of the beginning of the earliest period presented.
 - e. If retrospective application to all prior periods is impracticable, disclosure of the reasons why and a description of the alternative method used to report the change.
 - f. Presentation of the effect on financial statement subtotals and totals other than income from continuing operations and net income is not required.
- C. **Changes in Reporting Entity**
An accounting change that results in financial statements that are, in effect, the statements of a different reporting entity (i.e., a different group of companies comprise the reporting entity after the change).
- 1. **Reporting** Report the change by retrospectively applying the change to the financial statements of all prior periods presented to reflect the financial information for the new reporting entity for the periods. Do **not** report (1) the cumulative effect of the change on the amount of retained earnings at the beginning of the period in which the change is made or (2) pro forma effects on net income and earnings per share of retroactive application.
 - 2. **Examples** Examples include (a) presenting consolidated or combined statements in place of statements of individual companies, (b) changing specific subsidiaries comprising the group of companies for which consolidated financial statements are presented, and (c) changing the companies included in combined financial statements.
 - 3. **Disclosures** A description of both the nature of the change and the reason for it shall be disclosed in the period of the change. In addition, the effect of the change on income before extraordinary items, net income, other comprehensive income, and any related per-share amounts shall be disclosed for all periods presented.

D. Correction of an Error in Previously Issued Financial Statements

1. **Overview** Errors in financial statements result from mathematical mistakes, mistakes in the application of accounting principles, or the oversight or misuse of facts that existed at the time the financial statements were prepared. Errors commonly found in financial statements include the following.
 - a. Estimates based on unreasonable assumptions; for example, the use of an unrealistic depreciation rate.
 - b. Recording erroneous amounts for assets and equities. For example, incorrect footing of inventory totals would cause inventories to be misstated on the balance sheet.
 - c. Failure to record prepaid and accrued expenses.
 - d. The improper classification of assets as expenses and vice versa. The purchase price of a plant asset may be incorrectly charged to expense rather than an asset account.
 - e. In addition, the change from an accounting principle that is **not** generally accepted to one that **is** generally accepted is treated as the correction of an error; for example, a change from the direct write-off method to the allowance method of accounting for uncollectible accounts.
2. **Reporting** Any error in the financial statements of a prior period discovered subsequent to their issuance shall be reported as a prior-period adjustment by restating the prior period financial statements. Restatement requires that:
 - a. The cumulative effect of the error on previous periods prior to those presented shall be reflected in the carrying amounts of assets and liabilities as of the beginning of the first period presented.
 - b. An offsetting adjustment, if needed, shall be made to the opening balance of retained earnings for that period.
 - c. Financial statements for each individual prior period presented shall be adjusted to reflect correction of the period-specific effects of the error.
3. **Disclosures** The entity shall disclose that its previously issued financial statements have been restated, along with a description of the error. They shall also disclose the following:
 - a. The effect of the correction on each financial statement line item and any per-share amounts affected for each prior period presented.
 - b. The cumulative effect of the change on retained earnings or other appropriate components of equity or net assets in the statement of financial position, as of the beginning of the earliest period presented.
 - c. The resulting effects (both gross and net of applicable income tax) on the net income of prior periods should be disclosed in the annual report for the year in which the adjustments are made. When financial statements for a single period only are presented, this disclosure should indicate the effects of such restatement on the balance of retained earnings at the beginning of the period and on the net income of the immediately preceding period. When financial statements for more than one period are presented, which is ordinarily the preferable procedure; the disclosure should include the effects for each of the periods included in the statements. Such disclosures should include the amounts of income tax applicable to the prior period adjustments. Disclosure of restatements in annual reports issued subsequent to the first such post-revision disclosure would ordinarily not be required.

4. **Classification of Errors** Accounting errors may be classified by time of discovery or according to their effect on the balance sheet, income statement, or both.
- a. **Occurrence and Discovery in Different Periods** Errors that occur in one accounting period and are discovered in a subsequent accounting period are more involved: the cumulative effect of each error on periods prior to the period of discovery is calculated and recorded as a direct adjustment to the beginning balance of retained earnings.
 - b. **Occurrence and Discovery in Same Period** Errors that occur and are discovered in the same accounting period may be corrected by reversing the incorrect entry and recording the correct one or by correcting the account balances with a single entry.
 - c. **Effect on Balance Sheet** Only balance sheet accounts are affected, for instance, if the *Inventory* account is debited instead of the *Equipment* account or if *Notes Payable* is credited, instead of *Accounts Payable*. When the error is discovered, an entry is recorded to correct the account balances.
 - d. **Effect on Income Statement** Revenue or expense classification errors will affect only the income statement for the period. If *Sales Revenue* is credited instead of *Rent Revenue* or *Interest Expense* is debited instead of *Wage Expense*, the amounts presented on the income statement for these accounts will be misstated. Net income for the period, however, will not be affected. If the error is discovered prior to the year-end closings, an entry can be recorded to correct the account balances. If the error is discovered *in a subsequent period*, no correction is necessary. However, the restatement of comparative financial statements is required.
 - e. **Effect on Both Statements** Some errors affect both the balance sheet and the income statement, and may be classified in the following two ways:
 - (1) **Counterbalancing Errors** Counterbalancing errors will “correct” themselves over two consecutive accounting periods. Generally, a counterbalancing error will cause a misstatement of net income and balance sheet accounts in one period that will be offset by an equal misstatement in the following period. Balance sheet accounts and combined net income for both periods will be stated correctly at the end of the second period (ignoring tax effects).

Example 3 ▶ Counterbalancing Errors

A company neglects to record accrued wage expense at the end of a fiscal period. In the first year, the error would have the following effects:

<u>Income Statement</u>	<u>Balance Sheet</u>
Wage expense understated	Liabilities understated
Net income overstated	Retained earnings overstated

In the second year, the payment of accrued wage expense will be charged to wage expense of the current year causing the following effects:

<u>Income Statement</u>	<u>Balance Sheet</u>
Wage expense overstated	Accounts are correctly stated due to the counterbalancing effect on error.
Net income understated	

- (2) **Non-Counterbalancing Errors** Errors that are **not** counterbalancing cause successive balance sheet amounts and net income to be incorrectly stated until the errors are discovered and corrected. For example, suppose that instead of capitalizing the cost of an asset, the cost is charged to expense. In the year the error occurs, expenses will be *overstated* and net income *understated*. During the life of the asset, net income will be overstated by the amount of unrecorded

depreciation. Additionally, assets on the balance sheet will be understated throughout the service life of the unrecorded asset.

Chapter 11: Pages 11-22 through 11-23. Under the title heading “Interim Financial Reporting (APB 28) place in a new section V.D titled “Contingencies & Uncertainties”, reorganize and replace previous section V.D titled “Accounting Changes” to be V.E and reorganize so that now section V.E titled “Minimum Disclosures” is section V.F in the chapter with the following, accordingly:

D. Contingencies & Uncertainties

Contingencies and other uncertainties that could be expected to affect the fairness of presentation of financial data at an interim date should be disclosed in interim reports in the same manner required for annual reports. Such disclosures should be repeated in interim and annual reports until the contingencies have been removed, resolved, or have become immaterial.

E. Accounting Changes

Each report of interim financial information should indicate any change in accounting principles or practices from those applied in (1) the comparable interim period of the prior annual period, (2) the preceding interim periods in the current annual period and (3) the prior annual report. Whenever possible, companies should adopt any accounting changes during the first interim period of a fiscal year. Changes in accounting principles and practices adopted after the first interim period in a fiscal year tend to obscure operating results and complicate disclosure of interim financial information.

1. **Change in Accounting Principle** Changes in an interim or annual accounting principle made in an interim period should be reported by retrospective application in the period in which the change is made. The required disclosures are also presented in this same period in which the change was made. Financial statements of subsequent periods need not repeat the required disclosures.
2. **Change in Accounting Estimate** The effect of a change in an accounting estimate, including a change in the estimated effective annual tax rate, should be accounted for in the period in which the change in estimate is made. No restatement of previously reported interim information should be made for changes in estimates, but the effect on earnings of a change in estimate made in a current interim period should be reported in the current and subsequent interim periods and continue to be reported in the interim financial information of the subsequent year for as many periods as necessary to avoid misleading comparisons. The disclosures related to changes in accounting estimate are also required.
3. **Correction of an Error** In determining materiality for the purpose of reporting the correction of an error, amounts should be related to the estimated income for the full fiscal year and also to the effect on the trend of earnings. Changes that are material with respect to an interim period but not material with respect to the estimated income for the full fiscal year or to the trend of earnings should be separately disclosed in the interim period.

F. Minimum Disclosures

Disclosure requirements apply to reporting summarized financial data to security holders of **publicly** traded companies. When summarized financial data are regularly reported on a quarterly basis, information with respect to the current quarter and the current year-to-date or the last-twelve-months-to-date should be furnished together with comparable data for the preceding year.

1. Sales or gross revenues, provision for income taxes, extraordinary items, cumulative effect of a change in accounting principles, net income, and comprehensive income
2. Primary and fully diluted earnings per share data for each period presented
3. Seasonal revenue, costs or expenses
4. Significant changes in estimates or provisions for income taxes

5. Disposal of a segment of a business and extraordinary, unusual, or infrequently occurring items
6. Contingent items
7. Changes in accounting principles or estimates
8. Significant changes in financial position
9. Information about reportable operating segments, including revenues from external customers, intersegment revenues, a measure of segment profit or loss, material changes in total assets, a description of differences in segments or measurement of segment profit or loss, and a reconciliation of the total of segment profit or loss to consolidated income.

Chapter 16: Page 16-11. Add the following example titled “Example 5 ► Hedge of Foreign Currency Exchange Rate Risk” to the end of section III.B titled “Reporting Hedging Gains & Losses”.

Example 5 ► Hedge of Foreign Currency Exchange Rate Risk

On March 1, an entity anticipates acquiring equipment from a foreign manufacturer. The equipment is expected to be delivered in three months and will cost 1,200,000 FCU (Foreign Currency Units). The equipment will have a 5-year useful life and straight-line depreciation will be used. To hedge the foreign currency exchange rate exposure, the entity acquires forward contracts on the currency for delivery in three months. The current forward rate is \$1 = 0.5 FCU. The spot (forward) rate for June 1 (at settlement) is \$1 = 0.3 FCU. All of the hedging criteria are met. The entity takes a full year’s depreciation in the year of requisition.

Required: Provide the journal entries to record the acquisition of the foreign currency derivative, unrealized gain, realization of gain, and depreciation expense.

Solution:

3/1	Due from Broker (1,200,000/0.5)	2,400,000	
	Foreign Currency Derivative		2,400,000

Prior to settlement of contract:

6/1	Due from Broker		
	[(1,200,000 FCU × \$1/0.3 FCU) – \$2,400,000]	1,600,000	
	Unrealized Gain on Derivative—OCI		1,600,000

Settlement of contract and acquisition of equipment: The entity would settle the contract and purchase the equipment, resulting in equipment recorded at \$4,000,000.

Recorded each year for five years:

	Unrealized Gain on Derivative—OCI (\$1,600,000/5)	320,000	
	Gain on Derivatives		320,000
	Depreciation Expense (\$4,000,000/5)	800,000	
	Accumulated Depreciation		800,000

Chapter 17: Pages 17-1 through 17-20. Replace the entire chapter titled “Consolidated Financial Statements” with the following:

CHAPTER 17

CONSOLIDATED FINANCIAL STATEMENTS

- I. Introduction** 17-2
 - A. Overview..... 17-2
 - B. Chain of Interests..... 17-2
 - C. Exceptions 17-2
- II. Business Combinations** 17-2
 - A. Acquisition Method 17-2
 - B. Purchase Method 17-3
 - C. Pooling of Interests Method..... 17-4
- III. Purchase Method Application** 17-4
 - A. Acquisition 17-4
 - B. Record Combination..... 17-4
 - C. Subsequent Consolidation 17-9
 - D. Subsidiary Purchase..... 17-12
 - E. Subsidiary Disposal..... 17-13
 - F. Disclosures 17-13
- IV. Acquisition Method Application** 17-14
 - A. Differences From Purchase Method..... 17-14
 - B. Other Changes 17-15
- V. Noncontrolling Interests** 17-15
 - A. Introduction..... 17-15
 - B. Definition..... 17-15
 - C. Reporting..... 17-16
- VI. Transactions Between Affiliated Companies**..... 17-16
 - A. Intercompany Receivables, Payables & Loans..... 17-16
 - B. Intercompany Sales of Inventory..... 17-17
 - C. Intercompany Sales of Fixed Assets..... 17-18
 - D. Intercompany Bonds..... 17-19
- VII. Subsidiary Entity Records** 17-24
 - A. Traditional..... 17-24
 - B. Push-Down Accounting 17-24
- VIII. Combined Financial Statements** 17-24
 - A. Use 17-24
 - B. Procedures 17-24
- IX. Parent-Company Financial Statements** 17-25
 - A. Use 17-25
 - B. Procedures 17-25

Editor’s Note: Candidates testing prior to the *July-August 2009* exam window do **not** need to concern themselves with material referring to the acquisition method and noncontrolling interests. The acquisition method and controlling interests material came about as a result of SFAS 141(revised 2007) and SFAS 160. The material in these pronouncements is not eligible to be tested until the *July-August 2009* exam window.

EXAM COVERAGE: Historically, exam coverage of the topics in Chapter 17 has been 3 to 10 percent of the FAR section. The pooling of interests method is unlikely to be tested; it might appear as an incorrect response to a question. More information regarding exam coverage is included in Appendix B, *Practical Advice*.

CHAPTER 17

CONSOLIDATED FINANCIAL STATEMENTS

I. Introduction

A. Overview

Consolidated *Financial Statements* (ARB 51) states, the purpose of consolidated financial statements is to present the results of operations and the financial position of a parent company and all its subsidiaries as if the consolidated group were a single economic entity. Consolidated financial statements are considered more meaningful than separate financial statements and are usually necessary for a fair presentation when one of the entities in the consolidated group directly or indirectly has a controlling financial interest in the other entities. A controlling financial interest is usually ownership of a majority voting interest, generally ownership by one entity of more than 50 percent of the outstanding voting shares of another entity. All subsidiaries—all entities in which a parent has a controlling financial interest—should be consolidated.

B. Chain of Interests

On occasion, intercorporate stock ownership arrangements may indicate a chain of interests (e.g., A owns 80 percent of B, B owns 60 percent of C) the product of which (e.g., $80\% \times 60\% = 48\%$) does not represent control of the lower level subsidiary, where control is defined in terms of the 50 percent stock ownership minimum. In this instance, the preparation on consolidated statements is warranted, notwithstanding the 48 percent indirect interest of A Company in C Company. The product of the percentages of stock ownership in the chain is not a determinant in establishing a minimal condition for preparation of consolidated financial statements.

C. Exceptions

SFAS 94, *Consolidation of All Majority-Owned Subsidiaries*, as amended, provides that a majority-owned subsidiary should **not** be consolidated if control is temporary or does **not** rest with the majority owner. For example, if the subsidiary is in legal reorganization or in bankruptcy or operates under foreign exchange restrictions, controls, or other governmentally imposed uncertainties so severe that they cast significant doubt on the parent's ability to control the subsidiary. Consolidation of majority-owned subsidiaries is required even if they have nonhomogeneous operations, a large minority interest, or a foreign location.

II. Business Combinations

A. Acquisition Method

SFAS 141 (revised 2007), *Business Combinations*, requires an entity account for each business combination for which the acquisition date is on or **after** December 15, 2008, by applying the acquisition method. The acquisition method was previously called the purchase method but has some changes to improve reporting. It applies to all business entities, including mutual entities that previously used the pooling-of-interests method of accounting for some business combinations. A business combination is a transaction or event in which an acquirer obtains control of one or more businesses. Control is defined as ownership of a majority voting interest; as a general rule ownership by one company, directly or indirectly, of over fifty percent of the outstanding voting shares of another company. Transactions sometimes referred to as "true mergers" or "mergers of equals" are also business combinations. Applying the acquisition method requires:

- 1. Identifying the Acquirer** The acquirer is the entity that obtains control of the acquiree. The acquirer is usually the entity that transfers cash or other assets, or incurs liabilities, or issues its equity interests. Other factors that may identify the acquirer are the larger size of the entities involved and the entity initiating the combination.

2. **Determining the Acquisition Date** The acquisition date is the date on which the acquirer obtains control of the acquiree. Generally, the date on which the acquirer transfers the consideration, acquires the assets, and assumes the liabilities of the acquiree—the closing date. However, the acquirer might obtain control on a date before or after the closing date.
3. **Recognizing and Measuring Identifiable Assets Acquired, Liabilities Assumed, and any Noncontrolling Interest in the Acquiree** The assets and liabilities must be part of what the acquirer and acquiree exchanged in the business combination. The assets, liabilities, and any noncontrolling interest shall be measured at their acquisition-date fair values. Fair value is the price that would be received to sell an asset or paid to transfer a liability in orderly in an orderly transaction between market participants at the measurement date. An asset is identifiable if it either:
 - a. Is capable of being separated or divided from the entity and sold, transferred, licensed, rented, or exchanged either individually or together with a related contract, identifiable asset, or liability, regardless of whether the entity intends to do so; or.
 - b. Arises from contractual or other legal rights, regardless of whether those rights are transferable or separable from the entity or from other rights and obligations.
4. **Recognizing and Measuring Goodwill or a Gain From a Bargain Purchase**
 - a. **Goodwill** An asset representing the future economic benefits arising from other assets acquired in a business combination that are not individually identified and separately recognized. It is recognized as of the acquisition date and measured as the excess of (1) over (2) below:
 - (1) The aggregate of the consideration transferred plus the fair value of any noncontrolling interest plus, in a business combination achieved in stages, the acquisition-date fair value of the acquirer's previously held equity interest.
 - (2) The net of the acquisition-date amounts of the identifiable assets acquired and the liabilities assumed.
 - b. **Bargain Purchase** A business combination in which the amount in item a.(2) above exceeds the amount in item a.(1). If the excess remains after reassessing all assets and liabilities and reviewing the procedures used to measure their amounts, the acquirer shall recognize the resulting gain in earnings on the acquisition date.

B. Purchase Method

SFAS 141, *Business Combinations*, requires business combinations initiated **after** June 30, 2001, to be accounted for under the purchase method.

1. **Identifying the Acquiring Entity** Usually the entity that distributes cash or other assets, or incurs liabilities, or issues its equity interests. Commonly the acquiring entity is the larger entity or the entity that initiated the combination.
2. **Determining the Cost of the Acquired Entity** A cash payment by an acquiring entity shall be used to measure the cost of an acquired entity. Similarly, the fair value of other assets distributed as consideration and the fair values of liabilities incurred by an acquiring entity shall be used to measure the cost of an acquired entity. Direct costs of the business combination are also included in the cost of an acquired entity.
3. **Allocating the Cost of an Acquired Entity to Assets Acquired and Liabilities Assumed** The cost shall be allocated to the assets and liabilities based on their estimated fair values at date of acquisition. The tax basis of an asset or liability shall not be a factor in determining its fair value.

4. **Goodwill** The excess of the cost of an acquired entity over the net of the amounts assigned to assets acquired and liabilities assumed shall be recognized as an asset referred to as goodwill. Also, any acquired intangible asset that does not arise from contractual or legal rights and is inseparable from the acquired entity shall be included in the amount recognized as goodwill. After initial recognition, goodwill and other intangible assets shall be accounted for in accordance with the provisions of SFAS 142, *Goodwill and Other Intangible Assets*.
5. **Date of Acquisition** The acquisition date is ordinarily the date assets are received and other assets given, liabilities are assumed or incurred, or equity interests are issued. The parties may designate as the effective date the end of an accounting period between the dates a business combination is initiated and consummated. The basis for and method of determining the purchase price of an acquired entity, along with other related factors, shall be documented on this date.

C. Pooling of Interests Method

Business combinations initiated **before** June 30, 2001, that were exchanges of common stock for common stock and met several conditions, were allowed to be accounted for by the pooling of interests method.

1. **Summary** The pooling method accounted for a combination of two firms as a union of the ownership interests of two previously separated groups of stockholders. No sale or purchase was deemed to have occurred and no new goodwill was recorded. The assets and liabilities of the combining firms continued to be carried at their recorded amounts. The income of the constituents were combined and restated for each period presented.
2. **Consolidation Procedures** Consolidation procedures were similar to those for purchase or acquisition method subsidiaries. There was an adjustment of the carrying amount of the investment eliminating the capital and investment accounts. Also, the intercompany transactions were eliminated.

III. Purchase Method Application

A. Acquisition

The acquisition of a controlling interest in a company may be effected in different manners.

1. **Assets** The acquiring corporation may negotiate with management to obtain the assets (and assume the liabilities) of the company being acquired in exchange for cash, securities, or other consideration. Upon consummation, the acquired company ceases to exist as a separate economic, legal, and accounting entity. The surviving corporation records in its books the assets and liabilities of the acquired company. Note that this results in automatic consolidation for the current and subsequent periods, since the assets and liabilities of both companies are recorded in the same set of books.
2. **Equity Interests** An acquiring corporation may acquire ownership (or control) of a subsidiary by obtaining all (or a majority) of its outstanding common stock. The separate legal entity of the subsidiary is preserved and it continues to maintain its own separate set of books. For financial reporting purposes, the two companies may be viewed as a single reporting entity in accordance with ARB 51; this creates the need for consolidated financial statements.

B. Record Combination

Investment in the acquired corporation is recorded at the sum of the fair value of the consideration given or net assets received, whichever is more clearly determinable, and direct acquisition costs.

1. Assign Amounts to Assets and Liabilities Acquired

- a. **Marketable Securities** at fair values
- b. **Receivables** at present values of amounts to be received determined at appropriate current interest rates, less allowances for uncollectibility and collection costs

c. Inventories

- (1) **Finished Goods & Merchandise** at estimated selling prices less the sum of the costs of disposal and a reasonable profit allowance for the selling effort of the acquiring entity
- (2) **Work in Process** at the costs noted above plus the costs to complete
- (3) **Raw Materials** at current replacement costs

d. Plant and Equipment

- (1) **To Be Used** at current replacement cost for similar capacity
- (2) **To Be Sold** at fair value less cost to sell

e. Intangible Assets

- (1) **Goodwill and Deferred Income Taxes Previously Recorded by Acquired Entity** not recognized by the acquiring entity
- (2) **Recognized as an Asset Apart From Goodwill** at estimated fair values
 - (a) Arising from contractual or legal rights
 - (b) Other intangibles separable from entity

Exhibit 1 ▶ Examples of Intangible Assets Recognized

1. Marketing-Related Intangible Assets—Trademarks, trade names, service marks, collective marks, certification marks, trade dress (unique color, shape, or package design), newspaper mastheads, internet domain names, noncompetition agreements
2. Customer-Related Intangible Assets—Customer lists, order or production backlog, customer contracts and related customer relationships, noncontractual customer relationships
3. Artistic-Related Intangible Assets—Plays, operas, ballets, books, magazines, newspapers, other literary works, musical works such as compositions, song lyrics, advertising jingles, pictures, photographs, video and audiovisual material, including motion pictures, music videos, television programs
4. Contract-Based Intangible Assets—Licensing, royalty, and standstill agreements; advertising, construction, management, service or supply contracts; lease agreements; construction permits; franchise agreements; operating and broadcast rights; use rights such as drilling, water air, mineral, timber cutting, and route authorities; servicing contracts such as mortgage servicing contracts; employment contracts
5. Technology-Based Intangible Assets—Patented technology; computer software and mask works; unpatented technology; databases, including title plants; trade secrets, such as secret formulas, processes, recipes

- (3) **Other Intangibles Not Separable** are included in the amount recognized as goodwill

f. Other Assets (such as land, natural resources, and nonmarketable securities) at appraised values

Example 1 ▶ Purchase Price Allocation

Purchaser Inc., acquired for cash the assets and liabilities of the Acquired Co. Acquired's balance sheet prior to its dissolution is reproduced below. Book values approximate fair values except where otherwise indicated.

	BV	FV (if different)
Cash	\$ 3,000	
Accounts receivable	8,000	
Inventories	22,000	\$20,000
Held-to-maturity securities	50,000	55,000
Property, plant, and equipment, net (PPE)	60,000	50,000
Land	<u>20,000</u>	28,000
Total assets	<u>\$163,000</u>	
Current liabilities	\$ 4,000	
Long-term liabilities	20,000	
C/S, \$10 par	30,000	
APIC	50,000	
R/E	<u>59,000</u>	
Total liabilities and equity	<u>\$163,000</u>	

Required: Determine the amounts assigned to the individual assets and liabilities acquired for a purchase price of: (a) \$160,000; (b) \$120,000; and (c) \$60,000.

Solution:

Item, Dr. (Cr.)	Assigned Cost			
	FV	Case (a)	Case (b)	Case (c)
Cash	\$ 3,000	\$ 3,000	\$ 3,000	\$ 3,000
Accounts receivable	8,000	8,000	8,000	8,000
Inventories	20,000	20,000	20,000	20,000
Held-to-maturity securities	55,000	55,000	55,000	55,000
Current liabilities	(4,000)	(4,000)	(4,000)	(4,000)
Long-term liabilities	<u>(20,000)</u>	<u>(20,000)</u>	<u>(20,000)</u>	<u>(20,000)</u>
Total net FV, excluding PPE & land	<u>\$ 62,000</u>			
Purchase price		160,000	120,000	60,000
Net FV above		<u>(62,000)</u>	<u>(62,000)</u>	<u>(62,000)</u>
Excess (deficit) purchase price		98,000	58,000	(2,000)
Allocate to noncurrent assets and/or goodwill:				
PPE, net*	\$ 50,000	(50,000)	(37,179)	0
Land**	28,000	<u>(28,000)</u>	<u>(20,821)</u>	0
Goodwill (Extraordinary Income)		<u>\$ 20,000</u>	<u>\$ 0</u>	<u>\$ (2,000)</u>

* PPE = \$50,000 / (\$50,000 + \$28,000) × \$58,000 = \$37,179

** Land = \$28,000 / (\$50,000 + \$28,000) × \$58,000 = \$20,821

Example 2 ▶ Purchase of Partial Interest

Same as Example 1, except that the transaction involved the acquisition by Purchaser, Inc., of 80% of Acquired's common stock outstanding, in exchange for \$128,000 cash.

Required:

- Provide the journal entry to record the investment in Purchaser's books.
- Determine the adjustments needed if the carrying amounts of individual assets are to reflect FV only to the extent of proportionate ownership acquired (proprietary theory).
- Present a consolidation worksheet starting with the separate balance sheets of the two companies given in the first two columns of Solution c., below. Show eliminating entries and the consolidated balance sheet.

Solution:

a. Investment in Sub 128,000
 Cash 128,000

b. Item	80% × (FV – BV)	Adjustment
<u>Assets</u>		
Cash	80% × (\$ 3,000 – 3,000)	= \$ 0
A/R	80% × (8,000 – 8,000)	= 0
Inventories*	80% × (20,000* – 22,000)	= (1,600)
HTM Securities	80% × (55,000 – 50,000)	= 4,000
PPE	80% × (50,000 – 60,000)	= (8,000)
Land	80% × (28,000 – 20,000)	= <u>6,400</u>
Subtotal		\$ 800
<u>Liabilities</u>		
Current liabilities	80% × (4,000 – 4,000)	= 0
Long-term liabilities	80% × (<u>20,000</u> – <u>20,000</u>)	= 0
Net identifiable assets	80% × (<u>\$140,000</u> – <u>139,000</u>)	= <u>\$ 800</u>
Purchase price		\$ 128,000
FV of net assets	\$140,000	
% ownership	× 80%	
FV of 80% net assets		<u>(112,000)</u>
Goodwill		<u>\$ 16,000</u>

* For illustration purposes only; if inventories are overvalued by \$2,000, a write-down for that **entire** amount should be recorded in Acquired's books.

- c. [1] Entry to eliminate 80% of subsidiary's owners' equity account balances.
 [2] Entry to adjust assets to FV and record purchased goodwill.

Assets	Balance Sheets		Eliminations		Minority Interest (20%)	Consolidated Balance Sheet	
	Purchaser*	Acquired	Dr.	Cr.		Dr.	Cr.
Cash	\$ 20,000	\$ 3,000				\$ 23,000	
A/R	35,000	8,000				43,000	
Inventories	32,000	22,000		[2] \$ 1,600		52,400	
HTM securities	80,000	50,000	[2] \$ 4,000			134,000	
PPE (net)	150,000	60,000		[2] 8,000		202,000	
Land	40,000	20,000	[2] 6,400			66,400	
Invest. in sub (80% int.)	128,000			[1] 111,200			
				[2] 16,800			
Goodwill			[2] 16,000			16,000	
Total	<u>\$485,000</u>	<u>\$163,000</u>					
<u>Liab. & Equity</u>							
Cur. liabs.	\$ 25,000	\$ 4,000					\$ 29,000
Long-term liabs.	40,000	20,000					60,000
C/S, \$3 par (P)	90,000						90,000
APIC (P)	160,000						160,000
R/E (P)	170,000						170,000
C/S, \$10 par (S)		30,000	[1] 24,000		\$ 6,000		
APIC (S)		50,000	[1] 40,000		10,000		
R/E (S)		59,000	[1] 47,200		11,800		
Minority interest					(27,800)		27,800
Total	<u>\$485,000</u>	<u>\$163,000</u>	<u>\$137,600</u>	<u>\$137,600</u>	<u>\$ 0</u>	<u>\$536,800</u>	<u>\$536,800</u>

* All P's balance sheet amounts, except **Investment in Sub**, are arbitrary.

Example 3 ▶ Purchase of 100% Interest

Refer to the balance sheet and FV's provided for Acquired Co. in Example 1, except that the acquisition price consisted of the following: \$100,000 cash, 5,000 shares of Purchaser, Inc. (\$3 par, \$10 FV), and \$10,000 paid for legal fees and commissions directly related to the purchase.

Required: Provide the journal entry to record the transaction in Purchaser's books.

Solution:

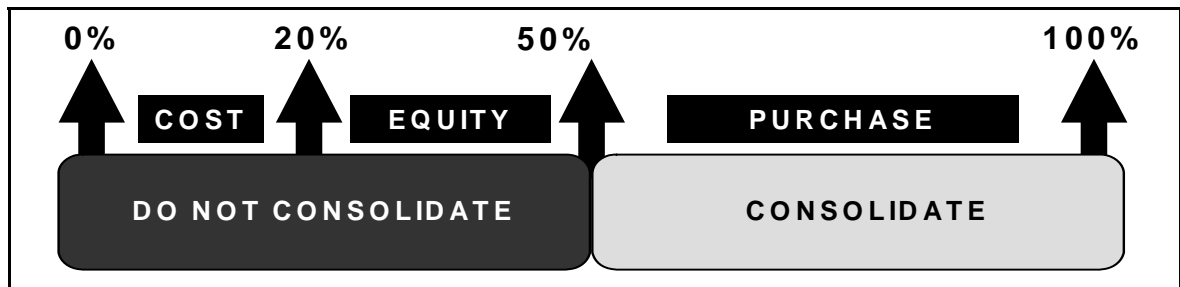
Investment in Sub (balancing figure)	160,000	
Cash (\$100,000 + \$10,000)		110,000
C/S, \$3 Par (5,000 × \$3)		15,000
APIC [(5,000 × \$10) – \$15,000 par]		35,000

NOTE: If the \$10,000 paid was for registration fees, APIC would be recorded at \$25,000 (\$35,000 – \$10,000) and the investment in subsidiary would be recorded at \$150,000 (the balancing figure).

C. Subsequent Consolidation

Subsequent to a business combination, the newly affiliated companies continue to maintain their separate accounting records. Consolidated financial statements are required by ARB 51, *Consolidated Financial Statements*, when a company owns more than 50% of the voting stock of another firm, with few exceptions. SFAS 141 and 141(revised 2007), *Business Combinations*, provide accounting and reporting standards.

Exhibit 2 ▶ Accounting for Investments



1. **Procedures** Consolidation procedures are partly determined by the consolidation method used. However, the final result, (the consolidated statements themselves) must be the same regardless of how the investment is carried on the parent's books. Furthermore, the eliminations and adjustments made as part of the consolidation procedures are **not** entered into the books of any of the companies; these adjustments are simply worksheet entries that are never formally journalized. Consolidation procedures involve the following.
 - a. **Adjust the Carrying Amount of Investment** Entries to adjust the carrying amount of the investment to the equity method balance.
 - b. **Eliminate Capital and Investment Accounts** Entries to eliminate the subsidiary's capital accounts (except for minority interest, if any), and the parent's investment account.
 - c. **Adjust for Depreciation on Excess Purchase Price Over Book Value of Assets**
 - d. **Eliminate Intercompany Transactions** Entries to eliminate intercompany balances and unrealized intercompany gains and losses.
2. **Frequency** Consolidation procedures must be performed every period in which financial statements are presented. Generally, the parent company carries its interest in a subsidiary in a single account, *Investment in Subsidiary*. This account is generally carried under one of two methods: the cost method or the equity method.

Example 4 ▶ Cost Method

The December 31, year 3, trial balances of Purchasing Inc., (P) and Subsidiary Corporation (S) are reproduced in the first two columns of the worksheet solution. P acquired its 80% interest in the common stock of S on January 1, year 1, for \$150,000 cash. At the time of acquisition, the recorded amounts of all assets and liabilities of S were deemed to approximate their FV, except equipment, which was undervalued by \$50,000 in S's books. The equipment has an estimated remaining useful life of 10 years and has been depreciated on the straight-line basis. S has not issued or retired stock since its incorporation. P carries its investment in S under the cost method.* Net income and dividend distributions for S have been as follows.

<u>Year</u>	<u>Net Income</u>	<u>Dividends Declared</u>
1	\$15,000	\$ 8,000
2	13,000	10,000
3	<u>16,000</u>	<u>5,000</u>
	<u>\$44,000</u>	<u>\$23,000</u>

* The **equity** method is generally required for **unconsolidated** investments exceeding 20% ownership; since the investment in S is to be consolidated, however, it is permissible for P to use the **cost method** for internal purposes.

Required: Provide elimination entries to consolidate the financial statements of P and S. Show all computations.

Solution: Three steps are recommended before attempting to complete the consolidation worksheet.

Step 1: Determine the net book value of S at the time of the 80% stock acquisition by P.

Beg. R/E + NI – Divids. = End R/E; Beg. R/E = End R/E – NI + Divids.	
Beg. R/E [\$79,000 – (\$15,000 + \$13,000) + (\$8,000 + \$10,000)]	\$ 69,000
C/S (from trial balance)	<u>20,000</u>
Net BV Co. S, January 1, year 1	<u>\$ 89,000</u>

Step 2: Determine amount of excess cost over BV of identifiable assets and purchased goodwill, if any.

Purchase price	\$150,000
Less: BV of net assets acquired [\$89,000 (Step 1) × .80]	<u>(71,200)</u>
Excess cost over BV of net assets acquired	78,800
Attributable to equipment (\$50,000 × .80)	<u>(40,000)</u>
Goodwill	<u>\$ 38,800</u>

Step 3: Determine amount of depreciation on excess purchase price over book value.

Excess FV over BV, equipment (Step 2)	\$ 40,000
Useful life (in years)	/ 10
Depreciation on excess, per year	<u>\$ 4,000</u>

Consolidation Worksheet, 80% Ownership, Cost Method Investment											
	Trial Balance		Eliminations				Consolidated	Minority	Controlling	Consolidated	
	Dr. (Cr.)		Dr.		Cr.		Income Statement	Interest	R/E	Balance Sheet	
	P	S					Dr. (Cr.)	Dr. (Cr.)	Dr. (Cr.)	Dr.	Cr.
Current assets	50,000	15,000								65,000	
Equipment	200,000	120,000	[3]	40,000	[5]	12,000				348,000	
Investment in S	150,000		[4]	8,000	[2]	16,000					
					[2]	63,200					
					[3]	78,800					
Goodwill			[3]	38,800						38,800	
Liabilities	(70,000)	(25,000)									95,000
C/S, \$1 par (P)	(100,000)										100,000
R/E, Jan. 1, year 3 (P)	(131,000)		[5]	8,000	[4]	8,000			(131,000)		
C/S, \$2 par (S)		(20,000)	[2]	16,000				(4,000)			
R/E, Jan. 1, year 3 (S)		\$(79,000)	[2]	63,200				(15,800)			
Revenues	\$(255,000)	(71,000)					(326,000)				
Expenses	160,000	55,000	[5]	4,000			219,000				
Subsidiary dividend income	(4,000)		[1]	4,000							
Dividends declared		5,000			[1]	4,000			1,000		
	<u>0</u>	<u>0</u>		<u>182,000</u>		<u>182,000</u>					
Consolidated NI							(107,000)		(107,000)		
Minority NI, 20% × (71,000 – 55,000)								(3,200)	3,200		
Minority interest								(22,000)			22,000
R/E, controlling interest									(234,800)		234,800
										<u>451,800</u>	<u>451,800</u>

Worksheet entries:

- To eliminate current year dividends.
- To eliminate 80% of S equity balances.
- To record goodwill and excess valuation of equipment, as determined in Step 2.
- To adjust investment account and R/E for S income and dividends during Years 1 through 2. $(80\% \times R/E) = 80\% \times (\$79,000 - \$69,000) = \$8,000$.
- To record accumulated depreciation (3 year) and current year expense.

Example 5 ▶ Equity Method

Same as Example 4, except that P maintains its investment in S under the **equity method** of accounting for investments. The trial balances of P and S are provided below. Note that while S's trial balance is the same as in Example 4, P's trial balance shows different amounts for the *Investment in S* account and *Subsidiary Income* account. This is the result of accounting for the investment in S under the equity method.

Required: Provide elimination entries to consolidate the financial statements of P and S. Show all computations.

Solution: A basic understanding of the **equity** method of accounting for common stock investments is essential in solving this problem. Before attempting to work through the elimination entries required, you should carefully study the T-account analysis of P's *Investment in Sub*, *Investment Income*, and *Retained Earnings* accounts, as illustrated below. While this step is not necessary in solving the problem, it will facilitate the solution and increase your understanding.

Investment in S			Subsidiary Income			Retained Earnings		
(a)	150,000	18,400 (c)	(e)	4,000	12,800 (b)	(d)	8,000	22,400 (b)
(b)	35,200	8,000 (d)						116,600 (f)
		4,000 (e)						
bal.	154,800	12/31, Year 3	12/31, Year 3	8,800	bal.	1/1, Year 3	131,000	bal.

T-Account entries:

- To record acquisition cost of 80% interest in S (credit to cash for same amount not shown).
- To record P's share of S's cumulative NI for year 1 through 3 $(80\% \times \$44,000)$. Note, the beginning (i.e., 1/1, year 3) balance of R/E has been credited for P's portion of the earnings for years 1 and 2 $[80\% \times (\$15,000 + \$13,000)]$. The portion of NI reported by S in Year 3 $(80\% \times \$16,000 = \$12,800)$ has been credited to *Subsidiary Income*, but is properly not reflected in the beginning (1/1, year 3) balance of R/E.

- (c) This entry represents the reduction in the carrying amount of the investment due to dividends declared by S during years 1 through 3. (80% × \$23,000).
- (d) These entries reduce the investment for the amount of depreciation of the excess cost over BV, for the years 1 and 2. Note, debit to R/E for similar reasons as in (b), above.
- (e) Current year additional depreciation—credit *Investment* account, as in (d), above, and charge *Subsidiary Income*.
- (f) This is not an entry or a balancing figure. It represents P’s balance in R/E not including the income recognized from S. This figure may be independently determined by an analysis of P’s cost method R/E, \$131,000 (see worksheet in Example 4, above). Under the cost method, R/E would have been increased by dividends received from S in prior years. Subtracting these dividends, we obtain \$116,600 [$\$131,000 - 80\% \times (\$8,000 + \$10,000)$].

NOTE: The R/E balance, \$131,000 credit is the same as shown in the “Controlling Interest” column (i.e., after adjustments) of the cost-method worksheet (see Example 4).

Consolidation Worksheet, 80% Ownership, Equity Method

	Trial Balance		Eliminations		Consolidated Income Statement		Minority Interest	Controlling R/E	Consolidated Balance Sheet	
	Dr. (Cr.)		Dr.	Cr.	Dr. (Cr.)	Dr. (Cr.)	Dr. (Cr.)	Dr. (Cr.)	Dr.	Cr.
	P	S								
Current assets	50,000	15,000							65,000	
Equipment	200,000	120,000	[3] 40,000	[4] 12,000					348,000	
Investment in S	154,800		[1] 4,000	[1] 12,800						
			[4] 12,000	[2] 16,000						
				[2] 63,200						
				[3] 78,800						
Goodwill			[3] 38,800						38,800	
Liabilities	(70,000)	(25,000)								95,000
C/S, \$1 par (P)	(100,000)									100,000
R/E, Jan. 1, year 3 (P)	(131,000)							(131,000)		
C/S, \$2 par (S)		(20,000)	[2] 16,000				(4,000)			
R/E, Jan. 1, year 3 (S)		(79,000)	[2] 63,200				(15,800)			
Revenues	(255,000)	(71,000)			(326,000)					
Expenses	160,000	55,000	[4] 4,000		219,000					
Subsidiary income	(8,800)		[1] 12,800	[4] 4,000						
Dividends declared		5,000		[1] 4,000			1,000			
	<u>0</u>	<u>0</u>	<u>190,800</u>	<u>190,800</u>						
Consolidated NI					<u>(107,000)</u>			(107,000)		
Minority NI, 20% × (71,000 – 55,000)							(3,200)	3,200		
Minority interest							<u>(22,000)</u>			22,000
R/E, controlling interest								<u>(234,800)</u>		<u>234,800</u>
									<u>451,800</u>	<u>451,800</u>

Worksheet entries:

- [1] To reverse current year subsidiary income (80% × \$16,000) and dividends (80% × \$5,000).
- [2] To eliminate 80% of S capital account balances.
- [3] To record goodwill and write-up equipment to FV at time of acquisition.
- [4] To record accumulated depreciation and current year expense.

D. Subsidiary Purchase

When a subsidiary is purchased during a year, there are alternative methods of dealing with the results of its operations in the consolidated income statement.

1. **Preferable Method** The preferable method is to include the subsidiary in the consolidation as though it had been acquired at the beginning of the period and then deduct near the

bottom of the consolidated income statement the preacquisition portion of earnings applicable to each block of stock.

2. **Alternative Method** The alternative method is to include in the consolidated statement only the subsidiary's revenues and expenses subsequent to the date of acquisition.

E. Subsidiary Disposal

Where an investment in a subsidiary is disposed of during the year, it is preferable to omit from consolidated statements all details of the subsidiary's operations and to merely show the equity of the parent in the earnings of the subsidiary prior to disposal as a separate line in the income statement (equity method).

F. Disclosures

The notes to the financial statements of a combined entity in the period in which a material business combination is completed should include the following information.

1. The name and brief description of the acquired entity and the percentage of voting equity interests acquired
2. The primary reasons for the acquisition and a description of the factors contributing to any recognition of goodwill
3. The period for which the results of operations of the acquired entity are included in the combined income statement
4. The cost of the acquired entity and, if applicable, the number and assigned value of shares of equity interests issued or issuable
5. A condensed balance sheet disclosing the amount assigned to each major asset and liability caption of the acquired entity at the acquisition date
6. Contingent payments, options or commitments and projected accounting treatment upon occurrence of the contingencies
7. The amount of purchased research and development assets acquired and written off in the period as having no alternative future use and the line item in the income statement that includes that amount
8. The description and reasons for any purchased price allocation, if any, that has not been finalized—in subsequent periods, the nature and amount of the adjustments must be disclosed
9. If the amounts assigned to goodwill or to other intangible assets acquired are significant in relation to the total purchase, the following must be disclosed:
 - a. For intangible assets subject to amortization, the amount assigned, the amount of residual value, and the weighted-average amortization period must be disclosed.
 - b. For intangible assets not subject to amortization, the total amount assigned and the amount assigned to any major intangible asset class must be disclosed.
 - c. For goodwill, the total amount and the amount that is expected to be deductible for tax purposes must be disclosed. In addition, if the combined entity is required to disclose segment information, the amount of goodwill by reportable segment must be disclosed, unless not practicable.
10. If a series of individually immaterial business combinations completed during the period are material in the aggregate, the number and brief description of entities acquired and the aggregate costs and amounts involved must be disclosed.

11. If the combined entity is a public business enterprise, the following supplemental information of a pro forma basis must be included:
 - a. Results of operations for the current period (and prior period if comparative statements are presented) as though the business combination had been completed at the beginning of the period (or prior period); and
 - b. At a minimum, the information shall display revenue, income before extraordinary items and the cumulative effect of accounting changes, net income, and earnings per share.

IV. Acquisition Method Application

A. Differences From Purchase Method

Though fundamentally similar, the following items provide an overview of the major differences between the acquisition method as applied by SFAS 141 (revised 2007), *Business Combinations*, and the purchase method.

1. **Assets Acquired and Liabilities Assumed Recognition** The acquisition method measures these and any noncontrolling interest at their fair values as of the acquisition date, with limited exceptions. The purchase method uses a cost-allocation process allocating the cost of the acquisition to assets acquired and liabilities assumed based on their estimated fair values. The purchase method resulted in some assets and liabilities not being recognized at the acquisition date and some others being recognized at other than their fair values at the acquisition date.
 - a. **Acquisition-Related Costs** The acquisition method requires these costs to be recognized separately from the acquisition. The purchase method requires these costs to be included as part of the acquisition and allocate them to the assets acquired and liabilities assumed.
 - b. **Restructuring Costs** The acquisition method requires restructuring costs that the acquirer expected but was not obligated to incur be recognized separately from the business combination. The purchase method requires these costs be recognized as if they were a liability assumed at the acquisition date.
2. **Noncontrolling Interest** The acquisition method requires the acquirer in a business combination achieved in stages (step acquisition) to recognize the identifiable assets and liabilities, as well as the noncontrolling interest in the acquiree, at the full amounts of their fair values. The requirement to measure the noncontrolling interest results in recognizing the goodwill attributable to the noncontrolling interest in addition to that attributable to the acquirer. The purchase method identifies the cost of each investment, the fair value of the underlying identifiable assets acquired, and the goodwill on each step in a combination achieved in stages. They are measured at a blend of historical costs and fair values.
3. **Contingencies**
 - a. **Initial Recognition** The acquisition method requires assets acquired and liabilities assumed arising from contractual contingencies as of the acquisition date be measured at their acquisition-date fair values. All other (noncontractual) contingencies would be measured this same way only if it was **more likely than not** that they meet the definition of an asset or liability in accordance with FASB Concepts Statement No. 6, *Elements of Financial Statements*. If this criteria is not met, noncontractual contingencies are accounted for in accordance with other generally accepted accounting principles as appropriate. The purchase method permits deferred recognition of pre-acquisition contingencies until the criteria for SFAS 5, *Accounting for Contingencies*, is met.

C. Reporting

SFAS 160 makes the following changes in accounting of consolidated financial statements:

1. Consolidated Income Statement Presentation

- a. New** Required that consolidated net income be reported at amounts that include the amounts attributable to both the parent and the noncontrolling interest. Also required is disclosure, on the face of the consolidated statement of net income, of the amounts of consolidated net income attributable to the parent and the noncontrolling interest.
- b. Previous** Net income attributable to the noncontrolling interest was generally reported as an expense or other deduction to consolidated net income. It was also often presented in combination with other financial statement amounts.

2. Changes in Parent's Ownership Interest Not Resulting in Deconsolidation A parent's ownership changes if the parent purchases more or sells some of its ownership interest in its subsidiary. It also changes if the subsidiary reacquires or issues more ownership interests.

- a. New** All of these transactions are considered equity transactions if the parent retains its controlling financial interest in the subsidiary. Also, the parent no longer is required to apply purchase accounting to acquisition of noncontrolling interests in a subsidiary.
- b. Previous** A decrease in the parent's ownership interest could be accounted in one of two ways: as equity transactions or as transactions with gain or loss recognition in the income statement. A parent's acquisition of noncontrolling ownership interests in a subsidiary was accounted for using the purchase method.

3. Deconsolidation A parent deconsolidates a subsidiary as of the date the parent ceases to have a controlling financial interest in the subsidiary.

- a. New** If a parent retains a noncontrolling equity investment in the former subsidiary, that investment is measured at fair value. The gain or loss on the deconsolidation is recognized in net income using the fair value of the noncontrolling equity investment.
- b. Previous** The carrying amount of any retained investment was not remeasured and it was used in determining any gain or loss on the deconsolidation of the subsidiary.

4. Disclosures Expanded disclosures are required that clearly identify and distinguish between the interests of the parent's owners and the interests of the noncontrolling owners of a subsidiary. Those expanded disclosures include a reconciliation of the beginning and ending balances of the equity attributable to the parent and noncontrolling owners. Also a schedule showing the effects of changes in a parent's ownership interest in a subsidiary attributable to the parent.**VI. Transactions Between Affiliated Companies****A. Intercompany Receivables, Payables & Loans**

- 1. Receivables and Payables** Originate from intercompany transactions such as the sale of inventory and fixed assets or the rendering of services. These receivables and payables appear in the affiliated company's trial balance at the end of the period; note, however, that no asset or liability exists outside the consolidated group. Elimination of the receivable/payable simply involves a "worksheet entry" reversing the original recording.
- 2. Intercompany Loans** These must also be eliminated from consolidated statements, in a manner similar to that used for receivables and payables. In addition, interest income and expense and interest accruals must be eliminated.

Example 6 ▶ Intercompany Loans

P lent \$10,000 on June 1, year 1 to S, its 90% owned subsidiary. The note is to be repaid May 30, year 2, with 12% interest. Partial trial balances of P and S are reproduced below.

	P	S
Note receivable—S	10,000	
Accrued interest on note	600	
Note payable—P		(10,000)
Accrued interest on note		(600)
Sales revenue	(50,000)	(20,000)
Interest revenue	(600)	0
Expenses	36,000	17,000
Interest expense		600
	<u>\$ 0</u>	<u>\$ 0</u>

Required: Provide the elimination entries related to the intercompany note. Also, compute consolidated net income and allocate it to controlling and minority interest.

Solution: Note that whereas interest is not an expense for the consolidated entity, it is nevertheless a cost of doing business for S. It must be included in S's net income in order to determine the minority interest in S's net income.

Notes Payable	10,000	
Accrued Interest Payable	600	
Notes Receivable		10,000
Accrued Interest Receivable		600
<i>To eliminate intercompany receivable/payable and related accrued interest</i>		
Interest Income	600	
Interest Expense		600
<i>To eliminate interest income and expense on intercompany notes</i>		

	P	S	Consolidated
Sales Revenue (CR)	\$(50,000)	\$(20,000)	\$(70,000)
Expenses	36,000	17,000	53,000
Minority interest in NI, 10% × (\$20,000 – \$17,000 – \$600)			240
Controlling interest in NI			<u>\$(16,760)</u>

B. Intercompany Sales of Inventory

Intercompany sales of merchandise create three problems.

- Sales and Cost of Goods Sold** The sale and CGS are recorded twice: first, the seller records a sale and related CGS as the merchandise is "sold" to the affiliated buyer; secondly, the buyer resells the goods to outsiders, also recording a sale and CGS. For consolidated purposes, however, it is obvious that only one sale has occurred.
- Gross Profit** When one company sells merchandise to its affiliate at a price above cost, the ending inventory of the buyer contains an element of unrealized gross profit. The gross profit is not realized to the economic entity until it is sold to outsiders. The preparation of consolidated financial statements requires that unrealized gross profit be eliminated.
- Minority Interest** Minority interest in the subsidiary's income must be based on the sales and CGS originally reported by the subsidiary. As was the case in interaffiliate interest income and expense, the minority income should reflect the expense incurred (or revenues obtained) in intercompany transactions. The sale, however, may not be recognized until after the goods have been sold to an outside buyer.

Example 7 ▶ Intercompany Sales of Inventory

Parent sells merchandise to its 90% owned Sub at 25% above cost. The following chart summarizes the transactions in intercompany sales at year-end.

	Parent's sales price (= cost to Sub)	Cost	Parent's gross profit	
Beginning inventory 1/1	\$ 50,000	\$ 40,000	\$ 10,000	(realized)
Sales	<u>200,000</u>	<u>160,000</u>	<u>40,000</u>	
Total	250,000	200,000	50,000	
Ending inventory 12/1	<u>(75,000)</u>	<u>(60,000)</u>	<u>(15,000)</u>	(unrealized)
Cost of goods sold	<u>\$175,000</u>	<u>\$140,000</u>	<u>\$ 35,000</u>	

Required: Provide the consolidation elimination entries.

Solution:

(1)	R/E		10,000	
	CGS			10,000
	<i>To adjust beginning R/E and CGS for the overstated beginning inventory</i>			
(2)	Sales		200,000	
	Purchases			200,000
	<i>To eliminate intercompany sales and purchases</i>			
(3)	CGS		15,000	
	Inventory			15,000
	<i>To eliminate unrealized gross profit in ending inventory</i>			

C. Intercompany Sales of Fixed Assets

Sales of fixed assets between members of an affiliated group may result in the recognition of gain or loss by the seller, if the selling price differs from the carrying amount of the asset. Again, no gain or loss has taken place for the consolidated entity; assets have merely been transferred from one set of books to another. Additional complications result from the fact that the buyer of the asset will record it in its books at the agreed upon purchase price; subsequent depreciation charges will be based upon this purchase price, thus requiring adjustment. In summary, an interaffiliate sale of fixed assets involves the following.

1. **Carrying Amount** In the year of sale, restore the carrying amount of the asset to its original BV and eliminate the gain (loss) recorded by the seller.
2. **Depreciation** For each period, adjust depreciation expense and accumulated depreciation to reflect the original BV of the asset.
3. **Retained Earnings** For periods subsequent to the year of sale, R/E must be adjusted to eliminate the gain (loss) contained therein.
 - a. If the parent is the seller, controlling interest R/E absorbs the entire adjustment.
 - b. If a less than 100 percent owned subsidiary is the seller, the adjustment to R/E should be allocated to the controlling and minority interests on the basis of their ownership ratio.

Example 8 ▶ Intercompany Sale of Depreciable Assets

Parent sells machinery for \$1,500 to its wholly owned subsidiary. The machinery cost Parent \$2,000 and accumulated depreciation at date of sale was \$1,000. Parent had been depreciating the machinery on the SL method over a 10-year life. Sub continues this depreciation method.

Required: Provide the elimination entries at the end of years 1 and 2.

Solution: The debit to RE is \$400 (\$500 – \$100). Thus, the yearly indirect increase in consolidated income (from decreasing depreciation expense) will cause the \$500 gain to be fully recognized by the seller by the end of the fifth year, when the asset is fully depreciated.

Year 1	Gain on Intercompany Sale of Assets	500	
	Machinery	500	
	Accumulated Depreciation		1,000
	<i>To eliminate gain and restore asset and accumulated depreciation accounts to their original balances</i>		
	Accumulated Depreciation	100*	
	Depreciation Expense (\$500 / 5)		100*
	<i>To adjust consolidated depreciation charges</i>		
	* Gain / Life remaining to buyer = Depreciation elimination per year		
Year 2	Retained Earnings	400	
	Machinery	500	
	Accumulated Depreciation		800
	Depreciation Expense		100

D. Intercompany Bonds

- Direct Sale & Purchase** A direct sale and purchase of bonds between affiliates poses problems similar to the interaffiliate lending and borrowing transactions already discussed. Intercompany receivables and payables (including accrued interest) must be eliminated, as well as interest income/expense. Note that in a direct acquisition of bonds, no gain or loss results to either party, even if a premium or discount is involved, since the net carrying amount of the bond liability on the issuer's books will always equal the bond investment amount on the purchaser's books.

Example 9 ▶ Direct Sale of Bonds

Parent purchases \$100,000 bonds from Sub on December 31, year 1. The bonds' stated interest rate is 10%. Parent pays \$110,000 for the bonds. The effective interest rate of the bonds is 8%.

Required: Prepare the consolidation elimination entry at the date of the transaction and at December 31, year 2.

Solution: On December 31, year 1, the following journal entries were made on the books of the acquirer and the issuer.

Acquirer (Parent)		Issuer (Sub)	
Investment in Bonds	110,000	Cash	110,000
Cash	110,000	Bonds Payable	100,000
		Premium on Bonds	10,000

The consolidation elimination entry required is

Bond Premium	10,000		
Bonds Payable	100,000		
Investment in Bonds		110,000	

During Year 2, the following journal entries would be made to record income and expenses.

Acquirer		Issuer	
Cash	10,000	Interest Expense	8,800*
Interest Income	8,800*	Bond Premium	1,200
Bond Investment	1,200	Cash	10,000

* Interest income or expense = Effective interest rate x Net carrying amount (8% x \$110,000).

The consolidation elimination entries required at the end of Year 2 are as follows.

Interest Income	8,800		
Interest Expense		8,800	
Bonds Payable	100,000		
Bond Premium	8,800		
Investment in Bonds		108,800	

2. **Third Party** A member of an affiliated group may issue its bonds to outsiders. These bonds may then be purchased from the outside parties by a second affiliate.
 - a. For consolidated purposes, the bonds have been retired, since they are no longer held by outsiders.
 - b. A gain or loss will typically result from the acquisition by the second affiliate of bonds originally issued by the first affiliate to outsiders. This occurs because the FV of bonds at the time of reacquisition is likely different than the carrying amount of the bond obligation on the issuer's books. No gain or loss is recorded by individual affiliates, yet a gain or loss on retirement must be recognized at the consolidated level.
 - c. This gain or loss will be periodically recognized by the issuer as the difference between interest expense to the issuer and interest income to the purchaser. Upon maturity of the bond issue, the entire consolidated gain (loss) realized at the time of reacquisition of the bond will have been amortized and no further adjustments will be necessary.

Example 10 ▶ Bonds Originally Issued to Third Parties (face amount)

P owns a 90% interest in S, acquired several years ago. P accounts for its investment in S under the equity method. No intercompany sales of fixed assets or inventories have taken place.

- On January 1, year 1, S issued to outsiders \$100,000, 8%, 10-year bonds at face amount. Interest is paid annually, on December 30.
- On January 1, year 3, P bought the entire bond issue, when the prevailing interest rate for that type of bond was 12%.
- Operating income before interest charges and revenue was as follows.

	P	S
Year 3	\$55,000	\$33,000
Year 4	60,000	30,000

Required: Provide elimination entries and allocate consolidated income to the minority and controlling interest for (a) year 3, and (b) year 4. Ignore income taxes.

Solution: A gain is calculated and recognized as follows.

\$100,000 × P (8, 12%)	\$40,388	P(8, 12%) = PV of \$1 in 8 years at 12%, 0.40388
\$ 8,000 × P _A (8, 12%)	<u>39,741</u>	P _A (8, 12%) = PV of \$1 annuity, 8 years at 12%, 4.96763
	<u>\$80,129</u>	

Carrying amount of bonds in S books	\$100,000
Less: Price paid by P to acquire bonds	<u>(80,129)</u>
Gain on retirement	<u>\$ 19,871</u>

a. The following entries would have been made by P and S during year 3

P		S	
Cash	8,000	Interest Expense	8,000
Investment in S Bonds	1,615	Cash	8,000
Interest Income	9,615		

Elimination entries are illustrated by the following partial consolidation worksheet:

	P		S		Eliminations		Consolidated
	Dr.	(Cr.)	Dr.	(Cr.)	Dr.	Cr.	Income Statement
							Dr. (Cr.)
Invest. in S bonds							
(\$80,129 + \$1,615)	81,744					81,744	
Bonds payable			(100,000)		100,000		
Operating income							
(excluding interest)	(55,000)		(33,000)				(88,000)
Interest income	(9,615)				9,615		
Interest expense			8,000			8,000	
Gain on retirement of S bonds						<u>19,871</u>	<u>(19,871)</u>
					<u>109,615</u>	<u>109,615</u>	
Consolidated NI (Cr)							<u>(107,871)</u>
Minority interest, 10% (\$33,000 – \$8,000 – \$1,615 + \$19,871)*							\$ 4,326
Controlling interest, \$55,000 + \$9,615 + (90% × \$43,256)							<u>103,545</u>
							<u>\$107,871</u>

* The entire gain on retirement is allocated to S, and interest expense is adjusted to reflect the current rate (12%). To understand the reasoning behind this, assume two transactions:

- (1) S retires \$100,000 BV bonds at a cost of \$80,129, realizing a \$19,871 gain.
- (2) S reissues debt for \$80,129 at face value. The interest rate on this debt is the prevailing rate, or 12%; therefore, interest expense for Year 3 is \$8,000 + \$1,615 = \$9,615 (i.e., 12% × \$80,129).

b. The following entries would have been made by P and S during year 4.

P		S	
Cash	8,000	Interest Expense	8,000
Bond Investment	1,809	Cash	8,000
Interest Income			
(\$81,744 × 12%)	9,809		

	P		S		Eliminations		Consolidated
	Dr.	(Cr.)	Dr.	(Cr.)	Dr.	Cr.	Income Statement Dr.(Cr.)
Invest. in S bonds (81,744 + 1,809)	83,553					83,553	
Bonds payable			(100,000)		100,000		
Operating income (excluding interest)	(60,000)		(30,000)				(90,000)
Interest income	(9,809)				9,809		
Interest expense			8,000			8,000	
Retained earnings, P	(XXX)					16,430*	
Retained earnings, S			(XX)			1,826*	
					<u>109,809</u>	<u>109,809</u>	
Consolidated NI (Cr)							(90,000)
Minority interest, 10% × (\$30,000 – \$8,000 – \$1,809)							\$ 2,019
Controlling interest, \$60,000 + \$9,809 + (90% × \$20,191)							<u>87,981</u>
							<u>\$ 90,000</u>

* Consolidated R/E must include the gain on retirement of the bonds (\$19,871) less the amount amortized prior to year 4 (\$1,615 additional interest expense charged to S in year 3, see part a, above). The remaining adjustment to R/E of \$18,256 is allocated to the controlling and minority interests in proportion to their ownership percentage.

Example 11 ▶ Bonds Originally Issued to Third Parties at Discount

On January 1, year 1, S issued to outside parties \$100,000, 8% bonds to yield 9% and due to mature on December 30, year 4. The bonds were purchased by P on January 1, year 3, when the prevailing interest rate for that type of bond was 12%. Operating income before interest charges and revenues was as follows.

Year	P	S
3	\$80,000	\$35,000
4	90,000	38,000

Required: Provide the consolidation worksheet entries to eliminate the intercompany bonds and allocate consolidated net income to the minority and controlling interests for (a) year 3, and (b) year 4. Ignore income taxes.

Solution:

\$100,000 × P (n = 4, i = 9%; 0.70843)	\$ 70,843
\$ 8,000 × P _A (n = 4, i = 9%; 3.23975)	<u>25,918</u>
Bond issue price, January 1, year 1	96,761
Face amount	<u>100,000</u>
Discount, January 1, year 1	<u>\$ 3,239</u>

Table 1—S Discount Amortization Schedule

Date	Cash payment	Interest expense	Amortization	Carrying amount
Jan. 1, year 1				\$ 96,761
Dec. 30, year 1	\$8,000	\$8,707	\$707	97,468
Dec. 30, year 2	8,000	8,772	772	98,240
Dec. 30, year 3	8,000	8,842	842	99,082
Dec. 30, year 4	8,000	8,918*	918	100,000

*\$1 difference due to rounding

\$100,000 × P (n = 2, i = 12%; 0.79720)	\$79,720
\$ 8,000 × P _A (n = 2, i = 12%; 1.6900)	<u>13,520</u>
Retirement price	93,240
Carrying amount in S books (Table 1)	<u>98,240</u>
Consolidated gain on retirement	<u>\$ 5,000</u>

Table 2—P Discount Amortization Schedule

Date	Cash payment	Interest expense	Amortization	Carrying amount
Jan. 1, year 3				\$ 93,240
Dec. 30, year 3	\$8,000	\$11,189	\$3,189	96,429
Dec. 30, year 4	8,000	11,571	3,571	100,000

a. Year 3 Partial Consolidation Worksheet

	P		S		Eliminations		Consolidated Income Statement
	Dr.	(Cr.)	Dr.	(Cr.)	Dr.	Cr.	Dr.(Cr.)
Investment in S bonds (Table 2)	96,429					96,429	
Bonds payable			(100,000)		100,000		
Discount (Table 1)			918			918	
Operating income (Cr) (excluding interest)	(80,000)		(35,000)				(115,000)
Int. income (Table 2)	(11,189)				11,189		
Int. expense (Table 1)			8,842			8,842	
Gain on retirement						<u>5,000</u>	(5,000)
					<u>111,189</u>	<u>111,189</u>	
Consolidated NI (Cr)							<u>(120,000)</u>
Minority interest, 10% (\$35,000 – \$11,189* + \$5,000)							\$ 2,881
Controlling interest, \$80,000 + \$11,189 + 90% (\$28,810)							<u>117,119</u>
							<u>\$120,000</u>

* See note following consolidated worksheet in Example 10. Computed by applying effective rate at time of purchase by P to the net payable (i.e., 12% × \$93,240 = \$11,189).

b. Year 4 Partial Consolidation Worksheet

	P		S		Eliminations		Consolidated Income Statement
	Dr.	(Cr.)	Dr.	(Cr.)	Dr.	Cr.	Dr.(Cr.)
Investment in S bonds (Table 2)	100,000					100,000	
Bonds payable			(100,000)		100,000		
Operating income (Cr) (excluding interest)	(90,000)		(38,000)				(128,000)
Int. income (Table 2)	(11,570)				11,570		
Int. expense (Table 1)			8,917			8,917	
R/E, P	(XXXX)					2,388*	
R/E, S			(XX)			<u>265*</u>	
					<u>111,570</u>	<u>111,570</u>	
Consolidated NI (Cr)							<u>(128,000)</u>
Minority interest, 10% (\$38,000 – \$11,570)							\$ 2,643
Controlling interest, \$90,000 + \$11,570 + 90% (\$26,430)							<u>125,357</u>
							<u>\$128,000</u>

* Gain on requirement of S bonds		\$ 5,000
Interest income, P	\$ 8,842	
Interest expense, S	<u>(11,189)</u>	
Less: Year 3 amortization:		<u>(2,347)</u>
Unamortized gain, adjust beginning R/E		<u>\$ 2,653</u>
Minority interest, 10%		\$ 265
Controlling interest, 90%		<u>2,388</u>
		<u>\$ 2,653</u>

VII. Subsidiary Entity Records

A. Traditional

Our review of business combinations has focused on (1) the recording by the parent company and (2) the required consolidation procedures. Historically, where separate incorporation is maintained, the subsidiary's financial records are not affected by either the acquisition or the consolidation.

B. Push-Down Accounting

Under push-down accounting, however, the subsidiary records purchase price allocations and subsequent amortization. The subsidiary records the allocations attributed to its identifiable net assets (e.g., inventory, land, building, equipment) and goodwill with a balancing entry to an *Additional Paid-In Capital* account. Every year thereafter, the subsidiary recognizes depreciation expense, as appropriate, on these various allocations.

- 1. Simplicity** Because the allocations and amortization are already entered into the records of the subsidiary, the use of push-down accounting simplifies the consolidation process.
- 2. Better Internal Reporting** In addition, push-down accounting provides better internal reporting. Since the subsidiary's separate figures may include additional depreciation expense resulting from the purchase, the net income reported by the subsidiary is a good representation of the impact that the acquisition has on the earnings of the business combination.

VIII. Combined Financial Statements

A. Use

There are circumstances where combined financial statements (as distinguished from consolidated statements) of commonly controlled companies are likely to be more meaningful than their separate financial statements. Combined financial statements are often prepared for a group of related companies (e.g., a group of unconsolidated subsidiaries) or a group of commonly controlled companies (e.g., one individual owns a controlling financial interest in several entities that are related in their operations). Consolidated statements are not appropriate if there is no investment by one affiliate in another to eliminate.

B. Procedures

Combined financial statements are prepared by combining the individual companies' financial statement classifications into one set of financial statements.

- 1. Intercompany Issues** Intercompany transactions, balances, and profits or losses are eliminated in the same manner as in consolidated statements.
- 2. Other Issues** If there are problems in connection with such matters as noncontrolling interests, foreign operations, different fiscal periods, or income taxes, they are treated in the same manner as in consolidated financial statements.

IX. Parent-Company Financial Statements**A. Use**

In addition to consolidated financial statements, parent-company financial statements may be needed to indicate the position of bondholders and other creditors or preferred shareholders of the parent. Parent-company financial statements are **not** a valid substitute for consolidated financial statements.

B. Procedures

Consolidating financial statements, in which one column is used for the parent and other columns for subsidiaries is often used to effectively present the pertinent information.
