Accounting for Multiple Entities

Chapter 15

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• We shall focus on five aspects of accounting for multiple entities:

  1. the acquisition of one company by another – combination
  2. the reporting of parent and subsidiary relationships – consolations and segment reporting.
  3. accounting for the acquisition of a company by acquiring stock directly from the stockholders – tender offers
  4. accounting for acquiring subsidiaries – push-down accounting
  5. foreign currency translation for international subsidiaries.

BISNESS COMBINATIONS

• combining two or previously separate business organizations into a single entity has been an observable phenomena.

• several factors may cause a business organization with another organization:
  - tax consequence.
  - growth and diversification
  - financial considerations
  - competitive pressure
  - profit and retirement.

accounting for business combinations:

• there are two methods of accounting for business combinations:
  1. purchase
  2. pooling of interest.
Accounting for business combination

**Purchase method**
- The asset of acquired company are **recorded** at their market value for group purchase of assets that is, the individual **fair market value** of each asset is recorded.
- Any liabilities assumed by the acquiring company are then deducted from this amount and any excess between the net asset received and the cash paid is recorded as **goodwill**.
- **Goodwill** is amortized over a period not to exceed 40 years.
- If the difference between the **net asset** and the **cash paid** is **negative** → noncurrent assets (other than investment) are **recorded**.
- If the balance of the noncurrent is **reduced to zero** → a deferred credit is created and amortized.
- Reported **income** for the new company will include the acquiring company's income for the entire year and the acquired company's income since the date of acquisition.

**Pooling interest method**
- Accounts for the combination as the uniting of ownership interests that is accounted for as an acquisition but rather as fusion of two or more previously separate entities.
- The recorded amounts of **assets** and **liabilities** of the merging companies are **added together** on the **balance sheet** of the combined corporation and **goodwill** is not recorded.
- The **par value** of the **stock** of the acquiring company, which was issued to obtain the acquired entity, replace the stock of the acquired entity.
- The remaining **stockholder's equity** amount for the two entities are then **combined**.
- **Income** for the new reporting unit includes the income since the last reporting date for each of the previously separate companies.
- **Example**, if P corporation acquired S corporation on 15-12-1998 and both companies fiscal year ended on 31-12, the combined corporation reports S net income for the entity year of 1998.
• The APB noted the two methods were not alternative for accounting for the same transaction and established specific criteria for determining whether a combination should be accounted for as a purchase or as a pooling of interest.

⇒ All transaction that involve the exchange of cash are to be recorded as purchase.

⇒ Exchange of voting stock are to be recorded as pooling of interest.

⇒ If any of the criteria are violate the combination must be recorded as a purchase these criteria classified as:

1. attributes of the combining companies.
2. manner of combining interest.
3. absence of planned transactions.

attributes of the combining companies:

1. each of the combining companies is independent and has not been a subsidiary or division of another corporation within two years before the plan of combination is initiated.

2. each of the combining companies is independent of the other combining companies (independent means no more than 10 percent investment in the outstanding voting stock of any combining company at the date of acquisition).

Manner of combining interest:

1. the combination is effected in a single transaction or is completed in accordance with a specific plan within one year after the plan is initiated.
2. A corporation offers and issue only common stock with rights identical to those of the majority of its outstanding voting common stock in exchange for substantially all the voting common stock interest of another company at the date the plan of combination it is completed.

3. None of the combining companies changes the equity interest of the voting common stock contemplation of effecting the combination within two years before the plan is initiated or between the date the plan is initiated and the date it is completed.

4. Each of the combining companies requires shares of voting common stock only for purpose other than business combination and no company requires more than a normal number of shares between the date the combination is initiated and completed.

5. The ratio of the interest of individual common stockholder to those of other common stockholders in a combining company remains the same as a result of the exchange of stock to effect the combination.

6. The voting rights to which the common stock ownership interests in the resulting combined corporation are entitled are exercisable by the stockholders; the stockholders are neither disadvantaged of nor limited in exercising those rights for a period.

7. The combination is resolved at the date the plan is completed and no provisions of the plan relating to the issue of securities or other considerations are awaiting absence of planned transactions.

1. The combined corporation does not agree directly or indirectly to retire or reacquire all or part of the common stock issued to effect the combination.
2. the combined corporation does not enter into other financial arrangements for the benefit of former stockholders of a combining company.

3. the combined corporation does not intend or plan to dispose of a significant part of the assets of the combining companies within two years after the combination other than disposals in the ordinary course of business of the formerly separate companies and to eliminate duplicate facilities or excess capacity.

- It should be emphasize that pooling of interests is appropriate only when there is an exchange of voting stock and each of the foregoing condition has been met.

- Where a combination has been effected by a cash transaction or any one of the foregoing conditions has been violated, the purchase method must be used.

- When the purchase method is appropriate for combinations involving the exchange of voting common stock, the fair market value of the securities exchange is the measure of the acquisition price.
CONSOLDAITIONS

- When a business organization acquires control over one or more others through the acquisition of a majority of the outstanding voting stock, stockholders of the acquiring company (the parent company) have an interest in the assets of the combine parent/subsidiary entity.

- The criteria for the preparation of consolidation financial statements were originally describe in Accounting Research Bulletin No. 51 as follows:

  1. a parent–subsidiary relation ship must exist.
  2. the parent exercises control over the subsidiary.
  3. the parent plans to maintain control over the subsidiary during the near future.
  4. the parent and subsidiary should operate as an integrated unit and non-homogeneous operation should be excluded.
  5. the fiscal years of the units should approximate each others.

- in the preparation of consolidated financial statements, two overriding principle prevail the first is balance sheet oriented while the second is income statement oriented

  1. the entity cannot own or owe itself.
  2. the entity cannot make a profit by selling to itself.

the concept of control

- the impetus for consolidation is the control of the parent company over the subsidiary.

- control is define as ‘the power of one entity to direct or cause the direction of the management and operating and financing policies of an other entity’.
• the following exceptions indicating and inability to control a majority – owned subsidiary are cited by SFAS No. 94:

1. the subsidiary is in a legal reorganization or bankruptcy.
2. there are sever governmentally imposed uncertainties.

• control implies that one entity has the power to use or direct to use of the assets of another entity by:

1. establishing the controlled entity's policies and its capital and operating budget.
2. selecting determining the compensation of and terminating personnel responsible for implementing the controlled entity's policies and decisions.

Theories of consolidation

There are two permanent theories of consolidation

Entity theory

- The consolidation group (parent company and subsidiaries) is an entity, separate from its owners.
- The emphasis is on control of the group of legal entities operating as a single unit.
- Consolidation assets belong to the consolidation entity and the income earned by investing in those assets are income to the consolidated entity rather than to parent company stockholders.
- The purpose of consolidated statements is to provide information to all shareholders- parent company stockholders and outside minority stockholders of the subsidiaries.

Parent company theory

- Parent company stockholders are viewed as having a proprietary interest in the net assets of the consolidated group.
- The purpose of consolidated statement is to provide information primarily for parent company stockholders.
- The resulting financial statements reflect a parent company perspective.
- The assets and liabilities of the subsidiary are substituted for the parent company's investment in the subsidiary, the parent company stockholders' equity is equal to consolidated stockholders' equity, and the subsidiary revenues, expenses, gains, the losses are substituted for the parent company's investment income in the subsidiary.
• each theory implies a unique philosophy regarding the **nature** and **purpose** of consolidated financial statements.

• **current practice** conforms strictly to neither theory; it retains elements of both theories.

**minority interest**

• when a portion of the stock of a subsidiary is owned by investors outside the parent company, this ownership interest is referred to as a **minority interest**.

• the **classification** of minority interests on consolidated balance sheets poses a problem.

• the prevailing pronouncement on consolidation, **APB No. 51** and **SFAS No. 94**, neither define what minority interests is nor describe how it should be treated in published financial statements; the prevailing consolidation theories imply different interpretations of the very **nature of minority interest**.

• **in practice**, minority interests has been variously:
  1. disclosed as a liability.
  2. separately presented between liabilities and stockholders' equity.
  3. disclosed as a part of stockholders' equity.

  **two alternative treatments**

  **Under parent theory**
  - Only parent company stockholders play a proprietary role; therefore, minority shares are on outside interest and should not be included in stockholders' equity.

  **Under entity theory**
  - Entity theories implies that minority interest is an equity interest. The consolidated enterprise is considered one economic unit and minority shareholders contribute resources in the same manner as parent company stockholders.
Proportionate consolidation

- due to the argument surrounding the inability to reach a consensus on the nature of minority interest, some accountants supporter an alternative, proportionate consolidation, it would ignore minority interest altogether.

- under this approach, the parent company would report only its share of the asset and liabilities of the subsidiaries entity, and no minority interest need be reported.

**goodwill**

- it is recorded when a purchase business combination occur.

<table>
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<tr>
<th>Under parent theory</th>
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<tr>
<td>In current practice, the measurement of goodwill is consistent with parent company theory.</td>
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<tr>
<td>Good will is recorded as the different between the cost of investment made to acquire the subsidiaries shares and the fair value of the parent company's proportionate share of the identifiable net assets of the subsidiary.</td>
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<tr>
<td>No good will is attribute to minority interest the result is that the value of minority interest reported on the consolidated financial statements is not effected by the consolidation process; thus, it reflect the minority interest's shares of the reported book value of the subsidiary entity.</td>
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<table>
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<tr>
<td>Because the emphasis is on the parent company, good will would be valued at it is total market value implied by the purchase price paid for the parent company investment.</td>
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<td>The equity interest in goodwill would be allocated between the parent company and minority interest.</td>
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<td>The result would be that the minority interest like the parent company interest would be measured at fair value.</td>
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<tr>
<td>The balance sheet would then reflect the total fair value of the goodwill under the control of the parent company.</td>
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• FASB supports:
  - **entity theory for** → the valuation of identifiable net asset
  - **parent company theory for** → the valuation of goodwill

**Drawbacks of consolidation**

• The growth of business combination has created companies with diversified operation, termed **conglomerate**.

• The result has been the aggregation of financial information from various lines of business into one set of financial reports.

• Each new business combination result in loss of some information to the investing public because previously reported date is now combined with existing data in consolidation financial reports.

• Some accountants would prefer that in addition to consolidated financial statements companies also report the separate financial statements of the individual companies that constitute the consolidated group.

**Segment reporting**

• **GAAP** do not require the reporting of separate financial statements of the companies comprising consolidated group.

• **Segment reporting** the reporting of financial information on a less than total enterprise basis, is require under **SFAS No. 14**

• **SFAS No. 14** requires corporation issuing a complete set of financial statements to disclose:
  1. the enterprise ’s operations in different industries.
  2. its foreign operations and export sales
  3. its major customers.
the requiring these disclosure, SFAS No. 14 provided the following definitions:

1. **industry segment**: component of an enterprise engaged in providing a product or service or group of related products and services primarily to unaffiliated customers for a profit.

2. **reporting segment**: an industry segment for which information is required to be reported by this segment.

3. **revenues**: sales to unaffiliated customers and intersegment transactions similar to those with unaffiliated customers.

4. **operating profit or loss**: revenue minus all operating expense including the allocation of corporate overhead.

5. **identifiable assets**: tangible and intangible enterprise assets that are used by the industry segment.

- **the major problems associated with these disclosure**:

  1. the determination of reportable segments.
  2. the allocation of joint costs.
  3. transfer pricing.

- **these procedures require a considerable amount of managerial judgment, and the following guidelines are presented**:

  1. **existing profit centers**: the smallest units of activity for which revenue and expense information is accumulated for internal planning and control purpose represents a logical starting point for determining industry segments.

  2. **management organization**: the company's internal organizational structure generally corresponds to management's view of the major segments.
3. **investor expectations**: the information provided should coincide with the type of information needed by the public.

4. **competitive factors**: although the disclosure of all industry segment information might injure company's competitive position, the required disclosure are not more detailed than those typically provided by an enterprise operating within a single industry.

**reportable segments**:

- **SFAS No. 14** requires that each industry segment that is significant to the enterprise as a whole be identified as a reportable segment and suggests the following separate tests for significance:

  1. its revenue, including unaffiliated customers and intersegment transfers, is 10 percent or more of combined revenue to all unaffiliated customers and intersegment transfers.

  2. the absolute amount of profit or operating loss is 10 percent or more of the greater in absolute amount of:

     a) the combined operating profit of all industry segments that did not incur an operating loss
     b) the combined operating loss of all industry segments that incurred an operating loss.

  3. its identifiable assets are 10 percent or more of the combined identifiable assets of all industry segments.

**disclosed information**:

- **SFAS No. 14** requires the following information to be presented for each of the reportable segments:

  1. revenue
  2. profitability
  3. identifiable assets
4. other disclosures:

   a) depreciation, depletion, and amortization for each segment
   b) capital expenditures of each segment.
   c) equity method investees that are vertically related and the geographic location of such investees.
   d) changes in accounting principles that relate to industry segments.

method of disclosures

- three alternative methods of disclosure of segmental information are allowed by SFAS No.14:
  1. within the body of the financial statements, with appropriate explanatory disclosures.
  2. entirely in the footnote to the financial statements.
  3. in a separate schedule that is included as an integral part of the financial statements.