5. Investments Requiring Consolidation

You only need to casually review the pages of most any business press before you will notice a story about one business buying another. Such acquisitions are common and number in the thousands annually. Typically, such transactions are effected rather simply, by the acquirer simply buying a majority of the stock of the target company. This majority position enables the purchaser to exercise control over the other company; electing a majority of the board of directors, which in turn sets the direction for the company. Control is ordinarily established once ownership jumps over the 50% mark, but management contracts and other similar arrangements may allow control to occur at other levels.

5.1 Economic Entity Concept and Control

The acquired company may continue to operate, and maintain its own legal existence. In other words, assume Premier Tools Company bought 100% of the stock of Sledge Hammer Company. Sledge (now a "subsidiary" of Premier the "parent") will continue to operate and maintain its own legal existence. It will merely be under new ownership. But, even though it is a separate legal entity, it is viewed by accountants as part of a larger "economic entity." The intertwining of ownership means that Parent and Sub are "one" as it relates to economic performance and outcomes. Therefore, accounting rules require that parent companies "consolidate" their financial reports, and include all the assets, liabilities, and operating results of all controlled subsidiaries. When you look at the financial statements of a conglomerate like General Electric, what you are actually seeing is the consolidated picture of many separate companies owned by GE.

5.2 Accounting Issues

Although the processes of consolidation can become quite complex (at many universities, an entire course may be devoted to this subject alone), the basic principles are straightforward. Assume that Premier's "separate" (before consolidating) balance sheet, immediately after purchasing 100% of Sledge's stock, appeared as follows:

PREMIER TOOLS COMPANY
Balance Sheet
March 31, 20X3

ASSETS			LIABILITIES		
Current Assets			Current Liabilities		
Cash	$ 100,000		Accounts payable	$ 80,000	
Trading securities	70,000		Salaries payable	10,000	
Accounts receivable	80,000		Interest payable	10,000	$ 100,000
Inventories	200,000	$ 450,000	Long-term Liabilities		
Long-term Investments			Notes payable	$ 190,000	
Investment in Sledge		400,000	Mortgage liability	110,000	300,000
Property, Plant & Equipment					$ 400,000
Land	$ 25,000		STOCKHOLDERS' EQUITY		
Buildings and equipment (net)	100,000	125,000			
Intangible Assets			Capital stock	$ 300,000	
Patent		225,000	Retained earnings	500,000	800,000
Total Assets		$1,200,000	Total Liabilities and Equity		$1,200,000

Notice the highlighted Investment in Sledge account above, indicating that Premier paid $400,000 for the stock of Sledge. Do take note that the $400,000 was not paid to Sledge; it was paid to the former owners of Sledge. Sledge merely has a new owner, but it is otherwise "unchanged" by the acquisition. Assume Sledge's separate balance sheet looks like this:

SLEDGE HAMMER COMPANY
Balance Sheet
March 31, 20X3

ASSETS			LIABILITIES		
Current Assets			Current Liabilities		
Cash	$ 50,000		Accounts payable	$ 80,000	
Accounts receivable	30,000		Salaries payable	20,000	$ 100,000
Inventories	20,000	$ 100,000	Long-term Liabilities		
			Notes payable		50,000
Property, Plant & Equipment					$ 150,000
Land	$ 75,000		STOCKHOLDERS' EQUITY		
Buildings and equipment (net)	275,000	350,000	Capital stock	$ 100,000	
			Retained earnings	200,000	300,000
Total Assets		$ 450,000	Total Liabilities and Equity		$ 450,000

Let's examine carefully what Premier got for its $400,000 investment. Premier became the sole owner of Sledge, which has assets that are reported on Sledge's books at $450,000, and liabilities that are reported at $150,000. The resulting net book value ($450,000 - $150,000 = $300,000) is reflected as Sledge's total stockholders' equity. Now, you notice that Premier paid $100,000 in excess of book value for Sledge ($400,000 - $300,000). This excess is quite common, and is often called "purchase differential" (the difference between the price paid for another company, and the net book value of its assets and liabilities). Why would Premier pay such a premium? Remember that assets and liabilities are not necessarily reported at fair value. For example, the land held by Sledge is reported at its cost, and its current value may differ (let's assume Sledge's land is really worth $110,000, or $35,000 more than its carrying value of $75,000). That would explain part of the purchase differential. Let us assume that all other identifiable assets and liabilities are carried at their fair values. But what about the other $65,000 of purchase differential ($100,000 total differential minus the $35,000 attributable to specifically identified assets or liabilities)?

5.3 Goodwill

Whenever one business buys another, and pays more than the fair value of all the identifiable pieces, the excess is termed "goodwill." This has always struck me as an odd term -- but I suppose it is easier to attach this odd name, in lieu of using a more descriptive account title like: Excess of Purchase Price Over Fair Value of Identifiable Assets Acquired in a Purchase Business Combination. So, when you see Goodwill in the corporate accounts, you now know what it means. It only arises from the purchase of one business by another. Many companies may have implicit goodwill, but it is not recorded until it arises from an actual acquisition (that is, it is bought and paid for in a arm's-length transaction).

Perhaps we should consider why someone would be willing to pay such a premium. There are many possible scenarios, but suffice it to say that many businesses are worth more than their identifiable pieces. A movie rental store, with its business location and established customer base, is perhaps worth more than the movies, display equipment, and check-out stands it holds. A law firm is hopefully worth more than its desks, books, and computers. An oil company is likely far more valuable than its drilling and pumping gear. Consider the value of a brand name that may not be on the books but has instead been established by years of marketing. And, let's not forget that a business combination may eliminate some amount of competition; some businesses will pay a lot to be rid of a competitor.

5.4 The Consolidated Balance Sheet

No matter how goodwill arises, the accountant's challenge is to measure and report it in the consolidated statements -- along with all the other assets and liabilities of the parent and sub. Study the following consolidated balance sheet for Premier and Sledge:

PREMIER TOOLS COMPANY
Balance Sheet
March 31, 20X3

ASSETS			LIABILITIES		
Current Assets			Current Liabilities		
Cash	$ 150,000		Accounts payable	$ 160,000	
Trading securities	70,000		Salaries payable	30,000	
Accounts receivable	110,000		Interest payable	10,000	$ 200,000
Inventories	220,000	$ 550,000	Long-term Liabilities		
Property, Plant & Equipment			Notes payable	$ 240,000	
Land	$ 135,000		Mortgage liability	110,000	350,000
Buildings and equipment (net)	375,000	510,000			$ 550,000
Intangible Assets			STOCKHOLDERS' EQUITY		
Patent	$225,000				
Goodwill	65,000	290,000	Capital stock	$ 300,000	
			Retained earnings	500,000	800,000
Total Assets		$1,350,000	Total Liabilities and Equity		$1,350,000

In the above illustration, take note of several important points. First, the Investment in Sledge account is absent because it has effectively been replaced with the individual assets and liabilities of Sledge. Second, the assets acquired from Sledge, including goodwill, have been pulled into the consolidated balance sheet at the price paid for them (for example, take special note of the calculations relating to the Land account). Finally, note the consolidated stockholders' equity amounts are the same as from Premier's separate balance sheet. This result is expected since Premier's separate accounts include the ownership of Sledge via the Investment in Sledge account (which has now been replaced by the actual assets and liabilities of Sledge).

It may appear a bit mysterious as to how the preceding balance sheet "balances" -- there is an orderly worksheet process that can be shown to explain how this consolidated balance sheet comes together, and that is best reserved for advanced accounting classes -- for now simply understand that the consolidated balance sheet encompasses the assets (excluding the investment account), liabilities, and equity of the parent at their dollar amounts reflected on the parent's books, along with the assets (including goodwill) and liabilities of the sub adjusted to their values based on the price paid by the parent for its ownership in the sub.

5.5 The Consolidated Income Statement

Although it will not be illustrated here, it is important to know that the income statements of the parent and sub will be consolidated post-acquisition. That is, in future months, quarters, and years, the consolidated income statement will reflect the revenues and expenses of both the parent and sub added together. This process is ordinarily straightforward. But, an occasional wrinkle will arise. For instance, if the parent paid a premium in the acquisition for depreciable assets and/or inventory, the amount of consolidated depreciation expense and/or cost of goods sold may need to be tweaked to reflect alternative amounts from those reported in the separate statements. And, if the parent and sub have done business with one another, adjustments will be needed to avoid reporting intercompany transactions. We never want to report internal transactions between affiliates as actual sales. To do so can easily and rather obviously open the door to manipulated financial results.