Study Unit Two

Advanced Financial Statements and Consolidations

2.1	*Statement of Changes in Equity and Equity Transactions*	*2*
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This study unit is the **second of seven** on **external financial reporting decisions**. The relative weight assigned to this major topic in Part 1 of the exam is **15%**. The seven study units are

- Study Unit 1: Introduction to Financial Statements
- **Study Unit 2: Advanced Financial Statements and Consolidations**
- Study Unit 3: Measurement, Valuation, and Disclosure: Assets -- Short-Term Items
- Study Unit 4: Measurement, Valuation, and Disclosure: Assets -- Long-Term Items
- Study Unit 5: Measurement, Valuation, and Disclosure: Liabilities
- Study Unit 6: Revenue, Impairment Recognition, and IFRS
- Study Unit 7: Integrated Reporting

This study unit discusses the statement of changes in equity, statement of cash flows, and consolidations, which are important to understand before moving on to Study Units 3 through 7. Topics covered in this study unit include

- The accounting equation and equity transaction analysis
- Retained earnings
- Common and preferred stock
- Treasury stock
- Operating, investing, and financing activities
- Consolidated financial statements
- Acquisition method, including goodwill

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2.1 Statement of Changes in Equity and Equity Transactions

Statement of Changes in Equity

A statement of changes in equity presents a reconciliation for the accounting period of the beginning balance for each component of equity to the ending balance.

Each change is disclosed separately in the statement. The following are the common changes in the equity component balances during the accounting period:

Item	Equity Component and Direction
Net income	Retained earnings ↑
Net loss	Retained earnings ↓
Distributions to owners (dividends)	Retained earnings ↓
Issuance of common stock	Common stock ↑
Issuance of common stock – portion above par	Additional paid-in capital (APIC) ↑
Total change in other comprehensive income (OCI)	Accumulated OCI ↑ or ↓
Repurchase treasury stock	Total stockholders' equity ↓

Example 2-1 Statement of Changes in Equity

XYZ Company
Statement of Changes in Equity
For the Year Ended December 31, Year 1

Opening balance, January 1, Year 1		$ 0
Common stock:		
Opening balance, January 1, Year 1	$ 0	
Stock issued	55,000	
Closing balance, December 31, Year 1		55,000
Retained earnings:		
Opening balance, January 1	$ 0	
Net income	26,350	
Dividends declared	0	
Closing balance		26,350
Closing balance, December 31, Year 1		**$81,350**

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As shown in Example 2-1 on the previous page, retained earnings is reconciled and reported as part of the statement of changes in equity. This reconciliation can be detailed in a statement of changes in retained earnings. It reconciles the beginning and ending balances of the account.

The following is a common example of retained earnings reconciliation:

Retained earnings beginning balance
+ Net income (loss) for the period
– Dividends distributed during the period
+ Positive (negative) prior-period adjustments
Retained earnings ending balance

Prior-Period Adjustments

Prior-period adjustments include changes in accounting principles and corrections of errors in prior-period financial statements. The cumulative effect of these adjustments impacts retained earnings in the statement of changes in equity. This topic is covered in more detail in Part 2 of the CMA exam in the Financial Statement Analysis section.

Common and Preferred Stock

The most widely used classes of stock are common and preferred. If only one class of stock is issued, it is treated as common, and each shareholder must be treated equally.

A company cannot favor one shareholder more than another. For instance, a dividend must be made equally and pro rata to every shareholder.

The following basic terminology is related to stock:

Stock Term	Definition
Authorized	Maximum amount of stock that a corporation may issue
Issued	Stock that has been sold to stockholders by the corporation
Outstanding	Stock currently held by stockholders

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Common shareholders are the owners of the firm and may also be referred to as common stockholders. They have voting rights, and they select the firm's board of directors and vote on resolutions. Common shareholders are not entitled to dividends unless declared by the board of directors. A firm may choose not to declare any.

- Common shareholders are entitled to receive **liquidating distributions** only after all other claims have been satisfied, including those of preferred shareholders. Liquidating distributions occur when a company is closing its business and returning capital to its shareholders. This characteristic of common stock is called **residual claim**.

Common shareholders ordinarily have **preemptive rights**.

- Preemptive rights give current common shareholders the right to purchase any additional stock issuances in proportion to their ownership percentages. This way the preemptive rights safeguard a common shareholder's proportionate interest in the firm.

Preferred stock has features of debt and equity. It is classified as equity and presented in the equity section of the firm's balance sheet.

- Preferred stock has a fixed charge, but payment of dividends is not an obligation. The payment of dividends is at the firm's discretion.
- Preferred shareholders tend not to have voting rights.
- Preferred shareholders have the right to receive (1) dividends at a specified fixed rate before common shareholders may receive any and (2) distributions before common shareholders, but after creditors, in the event of firm bankruptcy (liquidation).

The following are common features of preferred stock:

- **Cumulative preferred** stock accumulates unpaid dividends (called dividends in arrears). Dividends in arrears must be paid before any common dividends can be paid.
- Holders of **convertible preferred** stock have the right to convert the stock into shares of another class (usually common stock) at a predetermined ratio.

Treasury stock is the entity's own stock that was repurchased by the entity at some point after its initial issuance to shareholders.

- Treasury stock reduces the shares outstanding, not the shares authorized.
- Dividends are never paid to these shares.

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Equity Transactions

Issuance of Stock

The par value of stock is an arbitrary amount assigned by the issuer. Common and preferred stock are reported in the financial statements at par value. Additional paid-in capital (paid-in capital in excess of par) is increased for the difference between the cash received and the par value of the stock issuance.

Example 2-2 Issuance of Stock

A company issued 50,000 shares of its $1 par value common stock. The market price of the stock was $17 per share on the day of issue.

Assets	=	Liabilities	+	Stockholders' Equity
Cash $850,000 ↑				Common stock $50,000 ↑ Additional paid-in capital $800,000 ↑

Cash: 50,000 shares × $17 market price = $850,000
Common stock: 50,000 shares × $1 par value = $50,000
Additional paid-in capital: $850,000 cash – $50,000 common stock = $800,000

In the event that a par value has not been established by the company, the stock is referred to as "no-par stock." In this case, there is no need for an additional paid-in capital account.

Treasury Stock

Treasury stock is reported using one of two methods:

1. Under the **cost method**, treasury stock is recorded at the cost of the purchase.
   - Treasury stock is treated as a reduction to total stockholders' equity.
2. Under the **par value method**, treasury stock is recorded for the par value of the stock.
   - Treasury stock reduces total stockholders' equity.
   - Additional paid-in capital is reduced.
   - Retained earnings is decreased if the acquisition price is greater than the original issue price.

Treasury stock has no voting rights, receives no distributions in liquidation, and receives no dividends when the entity declares a dividend.



Author's Note

CMA candidates should be familiar with both methods to account for treasury stock. However, candidates should not expect questions that relate to comparing the results of the two methods.

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Example 2-3 Treasury Stock -- Acquisition Price > Original Issue Price

Parvenu reacquired 5,000 shares of its $1 par value common stock for $20 per share. This stock had originally been issued at $17 per share. Parvenu had no prior treasury stock transactions.

Cost method

Assets	=	Liabilities	+	Stockholders' Equity
Cash $100,000 ↓				Treasury stock $100,000 ↓

5,000 shares × $20 market price = $100,000

Par value method

Assets	=	Liabilities	+	Stockholders' Equity
Cash $100,000 ↓				Treasury stock $5,000 ↓ Additional paid-in capital $80,000 ↓ Retained earnings $15,000 ↓

Cash payment: 5,000 shares × $20 market price = $100,000
Treasury stock: 5,000 shares × $1 par value = $5,000
Additional paid-in capital: 5,000 shares × $16 original issue excess = $80,000
Retained earnings -- difference:
$100,000 cash payment – $5,000 treasury stock – $80,000 additional paid-in capital = $15,000

Example 2-4 Treasury Stock -- Acquisition Price < Issue Price

Parvenu reacquired 5,000 shares of its $1 par value common stock for $10 per share.

Cost method

Assets	=	Liabilities	+	Stockholders' Equity
Cash $50,000 ↓				Treasury stock $50,000 ↓

5,000 shares × $10 market price = $50,000

Par value method

Assets	=	Liabilities	+	Stockholders' Equity
Cash $50,000 ↓				Treasury stock $5,000 ↓ Additional paid-in capital $45,000 ↓

Cash payment: 5,000 shares × $10 market price = $50,000
Treasury stock: 5,000 shares × $1 par value = $5,000
Additional paid-in capital -- difference: $50,000 cash payment – $5,000 treasury stock = $45,000

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Cash Dividend

The most common form of dividend is a cash dividend. An entity declares a dividend based on a dollar amount per share. Each shareholder receives cash as the form of distribution.

- On the **declaration date**, the board of directors formally approves a dividend. A declaration of a dividend decreases the retained earnings account.
- All holders of the stock on the **record date** are legally entitled to receive the dividend. There is no impact on the firm's accounting equation on the record date.
- The **payment date** is the date on which the dividend is paid.

Example 2-5 Cash Dividend

On September 12, a company's board of directors declared a $3 per-share dividend to be paid on October 15 to all holders of common stock. On the date of declaration, 40,000 shares of common stock were outstanding.

Declaration date

Assets	=	Liabilities	+	Stockholders' Equity
		Dividends payable $120,000 ↑		Retained earnings $120,000 ↓

40,000 shares outstanding × $3 per share = $120,000

Payment date

Assets	=	Liabilities	+	Stockholders' Equity
Cash $120,000 ↓		Dividends payable $120,000 ↓		

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Property Dividend

When an entity declares a dividend consisting of tangible property,

1. The property is **remeasured to fair value** as of the date of declaration, and any gain or loss on the remeasurement is recognized in the income statement.
2. The carrying amount of retained earnings is decreased for the fair value of the property to be distributed.
3. The property is distributed as a dividend.

Example 2-6 Property Dividend

On August 1, a company's board of directors declared a property dividend (land) to be distributed on December 1 to holders of common stock. On August 1, the carrying amount of the land to be distributed is $50,000 and its fair value is $80,000. The journal entries to record the declaration and distribution of the property dividend are as follows:

August 1 -- Declaration date

Assets	=	Liabilities	+	Stockholders' Equity
Land $30,000 ↑		Property dividend payable $80,000 ↑		Gain on land remeasurement $30,000 ↑ Retained earnings $80,000 ↓

December 1 -- Payment date

Assets	=	Liabilities	+	Stockholders' Equity
Land $80,000 ↓		Property dividend payable $80,000 ↓		

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Stock Dividends and Stock Splits

A stock dividend involves no distribution of cash or other property. Stock dividends are accounted for as a reclassification of different equity accounts, not as liabilities.

The accounting for stock dividends depends on the percentage of new shares to be issued.

- **Small stock dividend.** An issuance of shares **less than 20% to 25%** of the previously outstanding common shares should be recognized as a **stock dividend**.
- **Large stock dividend.** An issuance of **more than 20% to 25%** of the previously outstanding common shares should be recognized as a **stock split in the form of a dividend**.

In accounting for a **stock dividend**, the **fair value** of the additional shares issued is reclassified from retained earnings to common stock (at par value) and the difference to additional paid-in capital.

Example 2-7 Small Stock Dividend

On May 1, a company's board of directors declared and paid a 10% stock dividend on the 45,000 shares of common stock outstanding ($1 par value). The stock was trading for $15 per share at the declaration date.

May 1 -- Declaration and payment date

Assets	=	Liabilities	+	Stockholders' Equity
				Common stock $4,500 ↑ APIC $63,000 ↑ Retained earnings $67,500 ↓

45,000 shares × 10% = 4,500 shares
Retained earnings: 4,500 shares × $15 market price = $67,500
Common stock: 4,500 shares × $1 par value = $4,500
Additional paid-in capital -- difference: $67,500 retained earnings – $4,500 common stock = $63,000

For a stock dividend that is accounted for as a **stock split in the form of a dividend**, the **par value** of the additional shares issued is reclassified from retained earnings to common stock.

Example 2-8 Large Stock Dividend

Continuing from Example 2-7, assume that a 40% stock split in the form of a dividend was declared.

May 1 -- Declaration and payment date

Assets	=	Liabilities	+	Stockholders' Equity
				Common stock $18,000 ↑ Retained earnings $18,000 ↓

45,000 shares × 40% = 18,000 shares
18,000 shares × $1 par value = $18,000

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Stock splits are issuances of shares that do not affect any aggregate par value of shares issued and outstanding or total equity. A stock split reduces the par value of each stock and increases the number of shares outstanding.

- No entry is made, and no transfer from retained earnings occurs.
- The primary purpose of a stock split is to improve the stock's marketability by reducing its market price and proportionally increasing the number of shares outstanding.

The following table summarizes the impact on the par value per share:

Item	Par Value Per Share
Small stock dividend	No change
Large stock dividend	No change
Stock split	Decrease

The following table summarizes the impact on the elements of the accounting equation:

Item	Common Stock	Additional Paid-In Capital	Retained Earnings	Total Stockholders' Equity
Small stock dividend	Increase	Increase	Decrease	No change
Large stock dividend	Increase	No change	Decrease	No change
Stock split	No change	No change	No change	No change

Limitations of the Statement of Changes in Equity

The financial statements report accrual-basis results for the period. The company may recognize revenue and/or expense and report net income before any cash was actually received and/or paid.

- The data for retained earnings are not sufficient for assessing the amount of funds actually available to be reinvested in the company or to pay debt.

The statement of changes in equity illustrates a company's equity based on a specific time period, which means equity may vary significantly a few days before or after publication of the statement.

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2.2 Statement of Cash Flows

The **primary purpose** of the statement of cash flows is to provide relevant information about the cash receipts and cash payments of an entity during the period.

- To achieve this purpose, the statement should provide information about cash inflows and outflows from the operating, investing, and financing activities of an entity. This is the accepted order of presentation.
- The statement of cash flows should help users assess the entity's ability to generate positive future net cash flows (liquidity), its ability to meet obligations (solvency), and its financial flexibility.

The statement of cash flows explains the change in cash and cash equivalents during the period. It shows where cash came from and what cash was used for during the period.

It reconciles the period's beginning balance of cash and cash equivalents with the ending balance.

Example 2-9 Summary of Cash Flow Statement

The following is an example of the summarized format of the statement of cash flows (only the headings). The amounts of cash and cash equivalents at the beginning and end of the year are taken from the balance sheet.

Entity A's Statement of Cash Flows for the Year Ended December 31, Year 1

Net cash provided by (used in) operating activities	$20,000
Net cash provided by (used in) investing activities	(5,000)
Net cash provided by (used in) financing activities	9,000
Net increase (decrease) in cash and cash equivalents during the year	$24,000
Cash and cash equivalents at beginning of year (January 1, Year 1)	6,000
Cash and cash equivalents at end of year (December 31, Year 1)	**$30,000**

As shown in Example 2-9, the cash flows in the cash flow statement are separated into three categories: operating activities, investing activities, and financing activities.

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Operating Activities

Operating activities are all transactions and other events that are not financing or investing activities.

- Cash flows from operating activities are primarily derived from the principal revenue-producing activities of the entity.
- They generally result from transactions and other events that enter into the determination of net income.

The following are examples of **cash inflows** from operating activities:

- Cash receipts from the sale of goods and services (including collections of accounts receivable)
- Cash receipts from royalties, fees, commissions, trading debt securities, and other revenue
- Cash received in the form of **interest** or **dividends**

The following are examples of **cash outflows** from operating activities:

- Cash payments to suppliers for goods and services
- Cash payments to employees
- Cash payments to government for taxes, duties, fines, and other fees or penalties
- Payments of **interest on debt**

Investing Activities

Cash flows from investing activities represent the extent to which expenditures have been made for resources intended to generate future income and cash flows.

The following are examples of **cash inflows** from investing activities:

- Cash receipts from the sale of property, plant, and equipment; intangible assets; and other long-lived assets
- Cash receipts from the sale and maturity of equity and debt instruments (such as held-to-maturity securities and available-for-sale debt securities) of other entities for investing purposes
- Cash receipts from repayment of advances and loans made to other parties

The following are examples of **cash outflows** from investing activities:

- Cash payments to acquire property, plant, and equipment; intangible assets; and other long-lived assets
- Cash payments to acquire equity and debt instruments (such as held-to-maturity securities and available-for-sale debt securities) of other entities for investing purposes
- Cash advances and loans made to other parties

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Financing Activities

Cash flows from financing activities generally involve the cash effects of transactions and other events that relate to the issuance, settlement, or reacquisition of the entity's debt and equity instruments.

The following are examples of **cash inflows** from financing activities:

- Cash proceeds from issuing shares of stock (obtaining resources from owners)
- Cash proceeds from issuing loans, notes, bonds, and other short-term or long-term borrowings

The following are examples of **cash outflows** from financing activities:

- Cash repayments of amounts borrowed
- Payments of cash dividends
- Cash payments to acquire or redeem the entity's own shares
- Cash payments by a lessee for a reduction of the outstanding liability relating to a finance lease

Major Statement of Cash Flows Note Disclosures

Information about all **noncash investing and financing activities** must be disclosed in the notes. Noncash investing and financing activities affect recognized assets or liabilities **but not cash flows**.

The following are examples of noncash investing and financing activities:

- Conversion of debt to equity
- Acquisition of assets by issuing stock, bonds, or notes payable
- Exchange of a noncash asset or liability for another

There are two methods of preparing the cash flow statement: the direct method and the indirect method. The direct method provides a detailed view of cash transactions, while the indirect method provides a reconciliation of net income to cash flow. The indirect method is more commonly used.



Author's Note

The indirect method is tested on the CMA exam, but the direct method is not.

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Indirect Method of Presenting Operating Cash Flows

Under the indirect method, the net cash flow from operating activities is determined by adjusting the net income of a business for the effect of the following:

- **Noncash revenue and expenses** that were **included in net income**, such as depreciation and amortization expenses, impairment losses, undistributed earnings of equity-method investments (covered in Study Unit 4, Subunit 2), and amortization of discount and premium on bonds
- Items **included in net income** whose cash effects relate to **investing or financing cash flows**, such as gains or losses on sales of property and equipment (related to investing activities) and gains or losses on extinguishment of debt (related to financing activities)
- All **deferrals** of past operating cash flows, such as changes during the period in inventory and deferred income
- All **accruals** of expected future operating cash flows, such as changes during the period in accounts receivable and accounts payable



Author's Note

The net income for the period as it is reported in the income statement was calculated using the accrual method of accounting. Therefore, adjustments must be made to reach the amount of cash flow from operating activities.



Success Tip

The following rules will help reconcile net income to net cash flow from operating activities under the indirect method:

Increase in current operating liabilities	Added to net income
Decrease in current operating assets	Added to net income
Increase in current operating assets	Subtracted from net income
Decrease in current operating liabilities	Subtracted from net income
Noncash losses and expenses included in net income	Added to net income
Losses and expenses whose cash effects are related to investing or financing cash flows	Added to net income
Noncash gains and revenues included in net income	Subtracted from net income
Gains and revenues whose cash effects are related to investing or financing cash flows	Subtracted from net income

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Below is an example of how a statement of cash flows is prepared using the indirect method. The balance sheets for Years 5 and 6 are given, along with Year 6 activities. The Year 6 cash flow statement is prepared in accordance with the rules in the Success Tip on the previous page.

Example 2-10 Statement of Cash Flows -- Indirect Method

Dize Corp's consolidated balance sheet accounts as of December 31, Year 6 and Year 5, are presented below. Information relating to Year 6 activities is to the left.

Information Relating to Year 6 Activities

- Cash dividends of $240,000 were declared and paid by Dize in Year 6.
- The accounts receivable balances at the beginning and end of Year 6 were net of allowances for credit losses of $50,000 and $60,000, respectively. Dize wrote off $40,000 of accounts receivable during Year 6.
- Current investments consist of Treasury bills maturing on 6/30/Year 7. They were acquired for cash on December 31, Year 6.
- Equipment costing $400,000 and having a carrying amount of $140,000 was sold on January 1, Year 6, for $150,000 in cash. Additional plant assets were purchased in Year 6 for cash.
- The provision for Year 6 income taxes was $210,000.
- 10,000 shares of common stock were issued in Year 6 for $22 a share.

	December 31	
Assets	Year 6	Year 5
Cash	$ 410,000	$ 400,000
Current investments	300,000	0
Accounts receivable (net)	480,000	510,000
Inventory	680,000	600,000
Prepaid expenses	15,000	20,000
Plant assets	1,730,000	1,000,000
Accumulated depreciation	(480,000)	(450,000)
Goodwill	90,000	100,000
Total assets	**$3,225,000**	**$2,180,000**
Liabilities and Equity		
Accounts payable	$ 825,000	$ 720,000
Interest payable	15,000	10,000
Income tax payable	20,000	30,000
Current debt	325,000	0
Deferred taxes	250,000	300,000
Common stock, $10 par	800,000	700,000
Additional paid-in capital	370,000	250,000
Retained earnings	620,000	170,000
Total liabilities & equity	**$3,225,000**	**$2,180,000**

The following computations are necessary to determine the net cash flows from operating, investing, and financing activities:

- **Net income.** The starting point for presenting the net cash flow from operating activities is net income (loss) for the period. Net income can be calculated as follows:

Ending retained earnings	$620,000
Dividends declared	240,000
Beginning retained earnings	(170,000)
Year 6, net income	**$690,000**

  - The $240,000 of cash dividends paid in Year 6 are a cash outflow from financing activities.
- **Accounts receivable.** The easiest way to determine the reconciling adjustment for accounts receivable is to calculate the change in their net amount (Accounts receivable – Allowance for credit losses). Net accounts receivable are current operating assets. A decrease in net accounts receivable of **$30,000** ($510,000 – $480,000) is **added** to net income to determine the net cash flow from operating activities.

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Example 2-10 -- Continued

- **Plant assets.** The items that affect the presentation of cash flow from operating activities are depreciation expense, gain or loss on disposal, and impairment loss.
  - **Depreciation expense** for Year 6 can be calculated as follows:

Ending accumulated depreciation	$480,000
Accumulated depreciation on items sold	260,000
Beginning accumulated depreciation	(450,000)
Depreciation expense	**$290,000**

    Depreciation expense is a noncash expense included in net income. Thus, **$290,000** is **added** to net income in determining the net cash flows from operating activities.
  - The **gain on disposal** of the equipment is **$10,000** ($150,000 cash received – $140,000 carrying amount). The cash effect is related to investing activities. Thus, it is **subtracted** from net income to determine the net cash flow from operating activities.
  - The $150,000 of cash proceeds from sale of equipment is a cash inflow from investing activities.
  - Plant assets purchased in Year 6 (cash outflow from investing activities) can be calculated as follows:

Ending plant assets at cost	$1,730,000
Plant assets sold at cost	400,000
Beginning plant assets at cost	(1,000,000)
Plant assets purchased	**$1,130,000**

    NOTE: The following equation may be useful for deriving the required information if the data given in the question are for the carrying amount (Cost – Accumulated depreciation) of the PPE item.

Beginning carrying amount	$XXX
Purchases during the period	XXX
Depreciation expense	(XXX)
Disposals during the period	(XXX)
Ending carrying amount	**$XXX**

- **Goodwill.** Goodwill is not amortized. Thus, the **$10,000** decrease in the amount of goodwill ($100,000 beginning balance – $90,000 ending balance) must be a result of impairment. A loss on impairment of goodwill is a noncash loss included in net income. Thus, it is **added** to net income in determining the net cash flow from operating activities. Goodwill is covered in detail in Subunit 2.3 and Study Unit 4, Subunit 5.
- **Current investments.** The purchase of current investments for $300,000 is a cash outflow from investing activities.
- **Common stock.** The proceeds from issuing common stock were $220,000 (10,000 × $22). This cash inflow from financing activities equals the sum of the increases in the common stock and additional paid-in capital accounts.
- **Inventory** is a current operating asset. Inventory increased by **$80,000** ($680,000 – $600,000). This amount is **subtracted** from net income in determining the net cash flow from operating activities.
- **Prepaid expenses** are current operating assets. Prepaid expenses decreased by **$5,000** ($15,000 – $20,000). This amount is **added** to net income in determining the net cash flow from operating activities.

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Example 2-10 -- Continued

- **Accounts payable** is a current operating liability. Accounts payable increased by **$105,000** ($825,000 – $720,000). This amount is **added** to net income in determining the net cash flow from operating activities.
- **Interest payable** is a current operating liability. Interest payable increased by **$5,000** ($15,000 – $10,000). This amount is **added** to net income in determining the net cash flow from operating activities.
- **Income tax payable** is a current operating liability. Income tax payable decreased by **$10,000** ($20,000 – $30,000). This amount is **subtracted** from net income in determining the net cash flow from operating activities.
- **Current debt.** The issuance of $325,000 of current debt ($325,000 – $0) is a cash inflow from financing activities.
- The **deferred tax liability** decreased by **$50,000** ($250,000 – $300,000). The decrease in the deferred tax liability increases net income by decreasing income tax expense. This decrease is a noncash item included in net income. Thus, it is **subtracted** from net income in determining the net cash flow from operating activities. Deferred taxes are covered in Study Unit 5, Subunit 3.

Dize Corp.
Consolidated Statement of Cash Flows -- Indirect Method
for the Year Ended December 31, Year 6

Cash flows from operating activities:		
Net income for Year 6	$ 690,000	
Decrease in accounts receivable	30,000	
Depreciation expense	290,000	
Gain on disposal of equipment	(10,000)	
Loss on impairment of goodwill	10,000	
Increase in inventories	(80,000)	
Decrease in prepaid expenses	5,000	
Increase in accounts payable	105,000	
Increase in interest payable	5,000	
Decrease in income tax payable	(10,000)	
Decrease in deferred tax liability	(50,000)	
Net cash provided by operating activities		**$ 985,000**
Cash flows from investing activities:		
Proceeds from sale of equipment	$ 150,000	
Purchases of plant assets	(1,130,000)	
Purchases of current investments	(300,000)	
Net cash used in investing activities		**$(1,280,000)**
Cash flows from financing activities:		
Dividends paid	$ (240,000)	
Proceeds from issuing common stock	220,000	
Proceeds from current debt	325,000	
Net cash provided by financing activities		**$ 305,000**
Net increase in cash		$ 10,000
Cash, beginning of year		400,000
Cash, end of year		**$ 410,000**



The CMA exam will not require you to prepare a cash flow statement that includes as much detail as Example 2-10. However, working through this example thoroughly will help reinforce your understanding of how a cash flow statement is prepared and equip you to answer cash flow questions on the exam.

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Limitations of the Statement of Cash Flows

A cash flow statement is not sufficient for forecasting the profitability of a firm because noncash items are not included in the calculation of cash flow from operating activities.

A cash flow statement may not represent the true liquid position of an entity.

- Decisions regarding large expenditures could be based on misconceived information when decisions are based only on the statement of cash flows.
- This statement must be viewed in conjunction with other financial statements, such as the balance sheet and the income statement.

Information can be manipulated in the statement of cash flows.

- For instance, management can schedule vendor payments to occur after year end to increase net cash flows reported on the statement of cash flows.

2.3 Consolidation Accounting

When one entity controls another entity, consolidated financial statements must be issued by a parent company regardless of the percentage of ownership. Control is defined as a controlling financial interest, and the entity that has control is the parent.

Consolidated Financial Statements

A **business combination** is a transaction in which an acquirer obtains control of another business.

A **controlling financial interest** is the direct or indirect ability to determine the direction of management and policies of the investee. Control usually is when one entity has direct or indirect ownership of **more than 50%** of the outstanding voting interests of another entity.

A **parent** is an entity with a controlling financial interest in one or more **subsidiaries**.

Consolidated statements present amounts for the parent and its subsidiaries as if they were a single economic entity.

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There are two primary **consolidation models** used for determining when financial control exists: the voting interest entity (VOE) model and the variable interest entity (VIE) model.

- Under the **VOE** model, financial control is determined by ownership of a majority voting interest, i.e., more than 50%.
- Under the **VIE** model, financial control exists even if the reporting entity does not have more than 50% voting ownership. This occurs when one entity has the power to direct the activities of another entity, such as when
  - The controlled entity does not have sufficient financial resources to support its ongoing operating needs, or the controlling entity absorbs the losses or benefits from the controlled entity
  - The controlling interest is generally arranged through a contract, not direct ownership

A parent and subsidiary may exist separately for an indefinite period, but consolidated financial statements must report them as a single economic entity.

Required consolidated reporting is an example of substance over form. Even if the two entities remain legally separate, the financial statements are more meaningful to users if they see the effects of control by one over the other.

Acquisition Method

When an entity gains control of another entity in a business combination, the combination must be accounted for using the **acquisition method**. This method

- Determines the acquirer and the acquisition date
- Recognizes and **measures at acquisition-date fair value** the
  - Identifiable assets acquired,
  - Liabilities assumed, and
  - Any noncontrolling interest (NCI) in the acquiree
- Recognizes goodwill or a gain from a bargain purchase

The consideration transferred in a business combination must be measured at **acquisition-date fair value**.

The acquirer is the entity gaining control, and the acquiree is the entity that is acquired.

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Calculation of Goodwill or Gain from a Bargain Purchase

Goodwill is an intangible asset reflecting the future economic benefits resulting from other assets acquired in a business combination that are not individually identified and separately recognized.

At the acquisition date, the acquirer recognizes and measures goodwill or a gain from a bargain purchase using the **goodwill equation**.

- A **positive outcome** of the equation results in recognition of **goodwill** in the consolidated balance sheet.
- A **negative outcome** of the equation results in recognition of a **gain from a bargain purchase** in the consolidated income statement.
- All components of the goodwill equation are measured at **acquisition-date fair value**.
- The identifiable net assets acquired equal the identifiable assets acquired minus liabilities assumed.
- Below is the **goodwill equation**:

Fair value of the consideration transferred
+ Fair value of any noncontrolling interest in the acquiree
+ Fair value of any previously held equity interest in the acquiree
– Fair value of identifiable net assets acquired
Positive outcome = Goodwill; Negative outcome = Gain from a bargain purchase

  - A noncontrolling interest exists when less than 100% of the acquiree was acquired.

Consolidated Financial Reporting – Acquisition-Date Balance Sheet

A balance sheet should be prepared that reports the financial position of the consolidated entity on the acquisition date. The steps to prepare this consolidated balance sheet are described below.

Step 1: Determine the amount of goodwill or gain from a bargain purchase recognized on the business combination.

Step 2: Prepare the assets section of the consolidated balance sheet by adding the assets of the parent and subsidiary. Assets and liabilities are reported at 100% of their fair value.

- In Example 2-11 on the next page, the carrying amounts of the subsidiary's assets and liabilities equal their fair values except that the fair value of land exceeds its carrying amount by $25,000. Therefore, land of the subsidiary is revalued to its fair value. Goodwill of $25,000 is also recognized.

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Example 2-11 Assets Section of the Balance Sheet

Consolidated assets are calculated as follows:

Current assets of parent	$140,000
Current assets of subsidiary	40,000
Consolidated current assets	**$180,000**
Noncurrent assets of parent	$180,000
Noncurrent assets of subsidiary	80,000
Excess fair value -- land	25,000
Goodwill	25,000
Consolidated noncurrent assets	**$310,000**

Step 3: Prepare the liabilities section of the consolidated balance sheet, adding the liabilities of the parent and subsidiary together.

Step 4: Determine the **noncontrolling interest**.

- An NCI (a minority interest) exists when less than 100% of the acquiree was acquired. An NCI is not reported for every asset and liability. The entire NCI is reported as a single component of consolidated equity.

Step 5: Because a combination is an acquisition of net assets, the subsidiary's equity accounts are eliminated.

- Except when there is a bargain purchase, the equity of the consolidated entity immediately after acquisition is the equity of the parent just prior to acquisition plus the fair value of the noncontrolling interest.

Step 6: Prepare the acquisition-date balance sheet.



Author's Note

Candidates are not required to prepare a consolidated balance sheet on the CMA exam.

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Example 2-12 Calculation of Goodwill

Entity C acquired 80% of the outstanding common stock of Entity D for $192,000. Entity D's acquisition-date fair values of identifiable assets and liabilities were $350,000 and $140,000, respectively. The acquisition-date fair value of NCI was $48,000. The goodwill is calculated as follows:

Consideration transferred		$192,000
Noncontrolling interest		48,000
Acquisition-date fair value of identifiable net assets (Assets – Liabilities) acquired:		
Assets	$350,000	
Liabilities	(140,000)	(210,000)
Goodwill		**$ 30,000**

Example 2-13 Calculation of Goodwill

Using the information provided in Example 2-12, assume that the acquisition-date fair value of the identifiable assets acquired was $400,000 (instead of $350,000). The gain from the bargain purchase is calculated as follows:

Acquisition-date fair value of identifiable net assets (Assets – Liabilities) acquired:		
Assets	$400,000	
Liabilities	(140,000)	$260,000
Consideration transferred		(192,000)
Noncontrolling interest		(48,000)
Gain from bargain purchase		**$ 20,000**

Consolidated Financial Reporting: Subsequent to the Acquisition Date

Consolidation Process

After the close of the fiscal year in which the combination occurred, the consolidated entity prepares its first full set of consolidated financial statements.

The following steps must be performed when preparing consolidated financial statements:

- All line items of assets, liabilities, revenues, expenses, gains, losses, and other comprehensive income (OCI) of a subsidiary are added item-by-item to those of the parent. These items are reported at the consolidated amounts.
- No investment in the subsidiary account is presented in the consolidated financial statements.
- Consolidated statements report the assets and liabilities of the subsidiary and the parent as if they are a single economic entity.
- All the equity accounts of the subsidiary are eliminated (not presented in the consolidated financial statements). Retained earnings of the consolidated entity at the acquisition date consist solely of the retained earnings of the parent.

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- Goodwill from the acquisition of a subsidiary is presented separately in the noncurrent assets section of the consolidated balance sheet.
- Intraentity balances, transactions, income, and expenses must be eliminated in full.
- NCI is reported separately in one line item in the equity section.

Consolidated Net Income

The consolidated income statement must present separate amounts for the following:

- Total consolidated net income
- Net income attributable to the NCI
- Net income attributable to the shareholders of the parent

Example 2-14 Net Income Attributable to Parent and Subsidiary

Below are the separate statements of income of Platonic and Socratic, excluding Platonic's share of income from Socratic, for the year ended December 31, Year 1. Platonic is the parent, and Socratic is the subsidiary.

Assume that (1) the ownership percentages were the same as at the acquisition date (80%), (2) no items of OCI were recognized in Year 1, and (3) no intraentity transactions occurred during Year 1.

Platonic's Year 1 consolidated statement of income is below.

Separate Income Statements for Platonic and Socratic

	Platonic	Socratic
Sales	$250,000	$120,000
Cost of goods sold	(120,000)	(70,000)
Selling and administrative expenses	(50,000)	(10,000)
Interest costs	(20,000)	0
Income tax expense	(21,000)	(14,000)
Net income	**$ 39,000**	**$ 26,000**

Year 1 Consolidated Income Statement

Sales	$370,000
Cost of goods sold	(190,000)
Selling and administrative expenses	(60,000)
Interest costs	(20,000)
Income tax expense	(35,000)
Net income	$ 65,000
Net income attributable to NCI	(5,200)
Net income attributable to Platonic's shareholders	**$ 59,800**

Net income attributable to NCI is $5,200 ($26,000 net income reported by Socratic × 20%).

Net income attributable to Platonic's shareholders is $59,800 [$39,000 + ($26,000 × 80%)].



Author's Note

Calculating the NCI is not covered on the CMA exam. Also, candidates are not required to prepare a consolidated income statement on the CMA exam. Rather, candidates should be able to demonstrate a general understanding of the consolidation process.

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Consolidated Financial Reporting – Intraentity Eliminations

Year-End Consolidated Financial Statements

Consolidating entities routinely conduct business with each other. The effects of these intraentity transactions must be eliminated in full during the preparation of the consolidated financial statements.

Consolidated financial statements report the financial position, results of operations, and cash flows as if the consolidated entities were a single economic entity.

- All line items in the consolidated financial statements must be presented at the amounts that would have been reported if the intraentity transactions had **never occurred**.
- After adding all the assets, liabilities, and income statement items of a parent and a subsidiary, **eliminating journal entries** for intraentity transactions must be recorded for proper presentation of the consolidated financial statements.

Reciprocal Balances

In a consolidated balance sheet, reciprocal balances, such as receivables and payables, between a parent and a subsidiary are eliminated in their entirety, regardless of the portion of the subsidiary's stock held by the parent.

Example 2-15 Intraentity Eliminations -- Reciprocal Balances

Platonic's separate balance sheet reports a $12,600 receivable from, and an $8,500 payable to, Socratic. Socratic's separate balance sheet reports an $8,500 receivable from, and a $12,600 payable to, Platonic. These balances are not reported on the consolidated balance sheet.

Intraentity Inventory Transactions – Gross Profit

Intraentity transactions resulting in gross profit require more complex treatment.

- Profit from the sale of inventory between consolidating entities is a component of the net income of the entity that sold the inventory.
- However, the consolidated entity recognizes profit on this exchange only in proportion to the inventory that is sold to nonaffiliated parties. Accordingly, the gross profit included in the inventory remaining on the purchaser's books must be eliminated from consolidated net income.

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- A year-end journal entry eliminates the gross profit recognized for the inventory remaining on the purchaser's books. It also reduces the inventory account to the balance it would have had if the intraentity transactions had never occurred.
  - The **sales** account is decreased for the amount recognized by the seller on the intraentity sale.
  - The **inventory** account is decreased for the amount equal to the unrealized intraentity gross profit (Seller's gross profit percentage × Inventory remaining on purchaser's books).
  - The **cost of goods sold** account is decreased for the difference between sales and inventory. The total decrease in both the sales account and cost of goods sold account is exactly equal to the amount of gross profit eliminated.

    Gross Profit Eliminated:

    Inventory remaining on purchaser's books × Seller's gross profit percentage

Example 2-16 Intraentity Eliminations -- Inventory Transaction

During the year, Platonic sold $100,000 of goods to Socratic on the same terms as sales made to third parties. Socratic sold 90% of this inventory to others. Socratic's cost of goods sold in connection with these outside sales was $90,000. Platonic had total sales of $800,000 and total cost of goods sold of $650,000 for the year.

Seller's gross profit percentage: [($800,000 – $650,000) ÷ $800,000] = 18.75%

Unsold inventory on purchaser's books	$ 10,000
Seller's gross profit percentage	× 18.75%
Unrealized intraentity gross profit	**$ 1,875**

In the eliminating entry, sales would be decreased $100,000, inventory would be decreased $1,875, and cost of goods sold would be decreased $98,125.

If no inventory from an intraentity transaction remains on the purchaser's books at the end of the reporting period, no adjustment is necessary for unrealized gross profit in ending inventory. The only adjustment for the intraentity sale is to eliminate (1) the sale recognized by the seller and (2) the cost of goods sold recognized by the purchaser.

Example 2-17 Intraentity Inventory Transaction -- None Retained

Using the data from Example 2-16, assume that Socratic (subsidiary) sold all of the inventory that was purchased from Platonic (parent) to third parties.

The year-end elimination entry would decrease sales $100,000 and decrease cost of goods sold $100,000.

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Intraentity Noncurrent Assets Transactions

Transfers of noncurrent assets require elimination of any gain or loss on the sale recognized on the intraentity transaction.

- All the accounts related to the asset transferred must be reported in the consolidated financial statements at the amounts that would have been reported if the intraentity transactions had never occurred.
- Thus, the **depreciation expense** recognized in the consolidated financial statements must be the depreciation expense that would have been recognized in the seller's separate financial statements.

Debt

When one entity holds the debt securities of another entity with which it is consolidated, the elimination is treated as an extinguishment of debt, with recognition of any resulting gain or loss. (Extinguishment of debt occurs when the borrower no longer has an obligation to pay the debt.)

- All accounts related to the debt, such as the maturity amount, interest receivable (payable), and interest income (expense), must be eliminated.
- The premium or discount on the debtor's and creditor's books, and any related amortization, is eliminated and recognized as a gain or loss on extinguishment in the period of purchase.

Reciprocal Dividends

When consolidated entities hold reciprocal equity stakes, the portion of dividends paid to each other must be eliminated from the consolidated financial statements.

- The portion of the parent's dividends paid to outside parties reduces consolidated retained earnings.
- The portion of the subsidiary's dividends paid to outside parties reduces any noncontrolling interest.

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Three Types of Consolidations

Full Consolidation Method

The previous coverage of consolidations is referred to as full consolidation.

Equity Method

The equity method is used when the investor has significant influence over a company (investee), i.e., an investment of 20% or more, but not more than 50%, in the voting stock of the investee.

Preparing consolidated financial statements is not necessary when applying the equity method.



The equity method is covered in more detail in Study Unit 4, Subunit 2.

Proportionate Consolidation Method

The proportionate consolidation method accounts for a joint venture of two or more entities.

Assets and liabilities of a joint venture are recorded on the balance sheet in proportion to the percentage of participation an entity maintains in the joint venture.

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