Accounting for the partial sale of ownership interests when control is retained

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ABSTRACT

In December 2007, the Financial Accounting Standards Board (FASB) issued Statement of Financial Accounting Standards 160, Noncontrolling interests in consolidated financial statements, which is now incorporated in Accounting Standards Codification (ASC) 810. The philosophy behind the FASB recommendations is the fair value concept or what is termed the acquisition method. Under this concept, the consolidated group is considered to be one economic unit for financial reporting purposes (Moonitz, 1942, 1951). The acquired business is consolidated in total regardless of the percentage of controlling ownership of the acquiring company. This approach incorporates the full fair value of the net assets of the subsidiary at the date of acquisition and noncontrolling interests are considered part of owners' equity.

One outcome of the adoption of the economic unit approach is that changes in the ownership interests, when the parent retains control, are considered equity transactions. This means that, from the group perspective, no gain or loss can be recognized as a result of a sale where ownership is retained. The purpose of this paper is to clarify and demonstrate the correct way to account for equity transaction sales in the books of the parent company and on consolidation.

Keywords: consolidation, noncontrolling interests, partial sale, equity transactions

INTRODUCTION

Accounting Standards Codification (ASC) 810, which incorporates Statement of Financial Accounting Standards (SFAS) 160, *Noncontrolling interests in consolidated financial statements*, requires changes in the ownership interests, when the parent retains control, be treated as equity transactions from the group perspective. Thus if a parent company sells twenty percent of its investment in a wholly owned subsidiary thereby reducing its ownership stake to eighty percent, then no gain or loss can be recognized from a group standpoint.

This paper addresses the procedures necessary to account for equity transaction sales from the perspective of the parent and the group. The literature review is followed by a critique of the current practice and an illustration of the methodology before offering a conclusion.

LITERATURE REVIEW

Prior to SFAS 160 any sale by the parent company of a portion, or all, of its investment in a subsidiary would result in a gain or loss being reported in the consolidated income statement regardless of percentage sold. This practice was altered with the implementation of SFAS 160 which states that:

> Changes in a parent's ownership interest while the parent retains its controlling financial interest in its subsidiary shall be accounted for as equity transactions (investments by owners and distributions to owners acting in their capacity as owners). Therefore, no gain or loss shall be recognized in consolidated net income or comprehensive income. The carrying amount of the noncontrolling interest shall be adjusted to reflect the change in its ownership interest in the subsidiary. Any difference between the fair value of the consideration received or paid and the amount by which the noncontrolling interest is adjusted shall be recognized in equity attributable to the parent (ASC 810-10-45-23).

ASC 810-10-55, formerly Appendix A of SFAS 160, gives implementation guidance and in section 4H states that the journal entry to record the sale of the shares of a subsidiary when the parent retains control is:

Dr. Cash
Accumulated other comprehensive income (Parent company)
Cr. Noncontrolling interest
Additional paid-in capital (Parent company).

The implication of the adjustment to the accumulated other comprehensive income is specific to the example given in ASC 810-10-55-4H and is not discussed further. This has led to the literature showing the following as the journal entry to record the sale in the parent company's books (see, for example, Bahnson, McAllister and Miller, 2008; Beams, Anthony, Clement, and Lowensohn, 2009; Deloitte, 2009; Ernst & Young, 2007; Fischer, Taylor, and Cheng, 2009; Hoyle, Schaefer, and Doupnik, 2011; Yang and Poon, 2008):

Dr. Cash
Dr./Cr. Paid-in capital
Cr. Investment.

This then results in the following consolidation entry assuming that the parent is using the equity method to account for the investment in the subsidiary:

Dr. Investment

Cr. Noncontrolling interest.

CRITIQUE OF THIS PRACTICE

Although ASC 810-10-55-4H refers to a journal entry, it is neither a consolidation entry nor is it a journal entry in the books of the parent company. The entry depicts the consequences to the group of the sale as can be seen from combining the parent's journal entry and the consolidation entry. The fact that this is called a journal entry in ASC 810-10-55-4H has led to the examples given in the current literature recording the partial sale incorrectly in the books of the parent. The resulting consolidation entry does result in the group financial statements correctly treat the partial sale as an equity transaction.

The FASB's conceptual framework clearly spells out when to recognize any gains and losses. Statement of Financial Accounting Concepts (SFAC) 5 states that "(r)evenues and gains are not recognized until realized …" and that this occurs when "… assets are exchanged for cash or claims to cash" (paragraph 83). In addition, SFAC 6 says "(t)he related terms realized and unrealized therefore identify revenues or gains or losses on assets sold and unsold, respectively" (paragraph 143). Since the parent company is a separate legal entity, the sale must result in a realized gain or loss in its books to correctly capture the economic consequences of the transaction. A consolidation entry would then adjust the results of the parent company to ensure that the sale is accounted for as an equity transaction from the group viewpoint.

ILLUSTRATION

To illustrate the proposed accounting of a partial sale of an investment in a subsidiary assume that Dunlop Limited acquired 7,000 of the 10,000 outstanding shares of Wilson Company on January 1, 2006 for $805,000. Wilson's book value was $1,000,000 on that date and any excess payment was attributed to a patent with a 10-year remaining useful life which results in additional amortization of $15,000 per year.

On January 1, 2010, Dunlop reported a $1,025,000 balance in the account "Investment in Wilson Company". Dunlop uses the equity method to account for this investment.

During 2010, Wilson reported net income of $120,000 and paid dividends of $40,000. These amounts were incurred evenly throughout the year. Dunlop reported net income of $150,000 and paid dividends of $60,000. On December 31, 2010, Dunlop sold 1,000 shares of its investment for $191,000 thus still retaining control of Wilson. The net income figure of Dunlop excludes any gain or loss on the sale of shares in Wilson, and excludes the equity income attributable to the investment in Wilson.

Part 1 of Table 1, shows the computation of the investment balance in Dunlop's books at the end of 2010. Part 2 shows the recommended journal entry in Dunlop's books from the sale of 1,000 shares in Wilson. The journal entry to record the sale differs from that given in the literature in that a gain of $38,071 is recognized rather than a credit to paid-in capital.

Table 2 details the 2010 consolidation working papers for the Dunlop group. The current year consolidation entry in respect of the partial sale must capture the group consequences of the deal as an equity transaction. This is achieved by eliminating the gain on sale recorded by Dunlop and transferring the amount to paid-in capital. The entry is:

Dr.	Investment	$ 152,929	
	Gain on sale	38,071	
Cr.	Noncontrolling interest		$ 152,929
	Paid-in capital		38,071

Combining this consolidation entry with the correct journal entry to record the sale in Dunlop's books yields the suggested entry in ASC 810-10-55, which is:

Dr.	Cash	$ 191,000	
Cr.	Noncontrolling interest		$ 152,929
	Paid-in capital		38,071

The current literature recommends the following journal entry to record the sale in Dunlop's books:

Dr.	Cash	$ 191,000	
Cr.	Investment		$ 152,929
	Paid-in capital		38,071

This will then result in the following consolidation entry to achieve the same result as suggested in ASC 810-10-55:

Dr.	Investment	$ 152,929	
Cr.	Noncontrolling interest		$ 152,929

Both the proposed method and the method used in the literature converge to the same end result and correctly record the partial sale as an equity transaction from the standpoint of the group. However, the examples given in the literature do not record a gain or loss on the sale in the parent's books.

In the textbooks that were reviewed, the examples dealing with the sale of a portion of the ownership interests where the parent retains control had the investor using the equity method. The reason for this is that if any other method is used by the parent company to account for its investment then the consolidation process becomes unwieldy. If Dunlop was using the cost basis the amount of the investment would be the original cost of $805,000 and the gain on the sale would be $76,000.

The approach adopted by the reviewed textbooks would result in the following journal entry in Dunlop's books to record the sale:

Dr.	Cash	$ 191,000	
Cr.	Investment		$ 115,000
	Paid-in capital		76,000

The consolidation entry would be:

Dr.	Investment	$ 115,000	
	Paid-in capital	37,929	
Cr.	Noncontrolling interest		$ 152,929

The approach recommended in this paper would result in the following journal entry in Dunlop's books to record the sale:

Dr.	Cash	$ 191,000	
Cr.	Investment		$ 115,000
	Gain on sale		76,000

The consolidation entry would be:

Dr.	Investment	$ 115,000	
	Gain on sale	76,000	

Cr.	Noncontrolling interest		$ 152,929
	Paid-in capital		38,071

Under the proposed approach the consolidation entry always offsets the credit to the investment and the gain or loss recorded in the journal entry of the parent. Therefore the consolidation entry is conceptually the same regardless of whether the parent uses the equity, partial equity or cost method to record its investment in the subsidiary.

The economic consequences of the partial sale of a portion of a subsidiary can be taken to its logical conclusion if the parent company sells its remaining stake. Assume that Dunlop sells the balance of its stake in Wilson on January 1, 2011 for $1.1 million. The journal entry in Dunlop's books to record this sale would be:

Dr.	Cash	$ 1,100,000	
Cr.	Investment..		$ 917,571
	Gain on sale...		182,429

The economic reality is that Dunlop sold an asset for $1,291,000 that had cost $805,000 and thus increased the wealth of its shareholders by a realized amount of $486,000. This clearly must be reported in the income statement of Dunlop. Under the method proposed in this paper, Dunlop would have recognized this amount as equity income of $265,500 over the five years it owned the investment and a gain on sale of $38,071 and $182,429 in 2010 and 2011 respectively.

For the method used in the literature, the journal entry to record the sale would have to be:

Dr.	Cash	$ 1,100,000	
	Paid-in capital	38,071	
Cr.	Investment..		$ 917,571
	Gain on sale...		220,500

The fact that the parent company is a separate legal entity must dictate that the gain on the sale be recorded at the time the sale takes place in order to comply with the realization principle. There is no economic rationale for a company to defer the recognition of a realized gain in its books even if it is still the parent after the sale.

CONCLUSION

Under the economic unit approach, any changes in the ownership percentage without the loss of control should be treated as equity transactions from the group perspective. The approach adopted by the examples given in the literature complies with this philosophy conceptually from the group perspective. However the examples do not correctly capture the economic consequences from the perspective of the parent company.

Table 3 compares the entries under the existing and proposed methods. In the books of the parent company the proposed method records a gain or loss on the sale whilst the current method treats the sale as an equity transaction. Although both methods arrive at the same overall result from the group perspective, it is argued that the proposed method is conceptually superior in that it records the economic consequences of the transaction correctly in the books of the parent company. The consolidation entry then reverses the gain or loss to reflect the fact that event is an equity transaction from the group perspective.

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Table 1
Analysis of the investment and the journal entry to record the sale

1. Dunlop’s investment in Wilson at December 31, 2010 using the equity method

Investment balance at January 1, 2010		$ 1,025,000
Recognized during 2010:	Income accrual ($120,000 x 70%)	84,000
	Dividends ($40,000 x 70%)	(28,000)
	Amortization ($15,000 x 70%)	(10,500)
Balance at December 31, 2010 before the sale		1,070,500
Less: Sold (1/7 x 1,070,500)		(152,929)
Investment balance at December 31, 2010		$ 917,571

2. Dunlop's journal entry to record the sale

Dr.	Cash	$ 191,000	
Cr.	Investment		$ 152,929
Cr.	Gain on sale		38,071

Table 2
Consolidation working papers for the Dunlop group for 2010

1. Analysis of consideration paid

Description	Total	Useful life	Amortization
Consideration paid	$ 805,000		
Fair value of noncontrolling interest (805 x 3/7)	345,000		
Fair value of Wilson	1,150,000		
Less: Net book value	1,000,000		
Excess of fair value over book value	150,000		
Allocation of excess:			
Patent	$ 150,000	10 years	$ 15,000
Total allocated	150,000		

2. At-acquisition consolidation entry

Dr.	Owners' equity	$ 1,000,000	
	Patent	150,000	
Cr.	Investment		$ 805,000
	Noncontrolling interest		345,000

Eliminates owners' equity and investment, fairly values net assets and records noncontrolling interest.

3. Consolidation entries from acquisition to the beginning of the current year

Dr.	Retained earnings (220/.7)	$ 314,286	
Cr.	Investment (1,025 – 805)		$ 220,000
	Noncontrolling interest (220 x 3/7)		94,286

Eliminates the change in equity of Wilson based on the equity method.

Dr.	Retained earnings	60,000	
Cr.	Patent (15 x 4 years)		60,000

Amortizes the fair value adjustment to the patent.

4. Current year consolidation entries

Dr.	Equity income	$ 73,500	
Cr.	Investment		$ 73,500

Eliminates the equity income recorded by Dunlop.

Dr.	Investment (70%)	28,000	
	Noncontrolling interest (30%)	12,000	
Cr.	Dividends paid		40,000

Eliminates the dividends paid by Wilson.

Dr.	Amortization expense	15,000	

Cr.	Patent		15,000
Amortizes the fair value adjustment to the patent.			
Dr.	Noncontrolling interest - income	31,500	
Cr.	Noncontrolling interest [(120 – 15) x 30%]		31,500
Records the noncontrolling interest's share of the net income of Wilson.			
Dr.	Investment	152,929	
	Gain on sale	38,071	
Cr.	Noncontrolling interest		152,929
	Paid-in capital		38,071
Records the sale by Dunlop as an equity transaction.			

Table 3
A summary of the entries for the current and proposed methods

1. Journal entry in the books of the parent company

Entries for the current methodology		Entries for the proposed methodology	
Dr.	Cash	Dr.	Cash
Dr./Cr.	Paid-in capital	Cr.	Gain on sale (or Dr. Loss on sale)
Cr.	Investment	Cr.	Investment

2. Consolidation entry

Entries for the current methodology		Entries for the proposed methodology	
Dr.	Investment	Dr.	Investment
Cr.	Noncontrolling interest	Dr.	Gain on sale (or Cr. Loss on sale)
		Dr./Cr.	Paid-in capital
		Cr.	Noncontrolling interest

3. Overall impact from the group perspective

Entries for the current methodology		Entries for the proposed methodology	
Dr.	Cash	Dr.	Cash
Dr./Cr.	Paid-in capital	Dr./Cr.	Paid-in capital
Cr.	Noncontrolling interest	Cr.	Noncontrolling interest