GENERAL

answers to ch 16 advanced accounting solutions

Published: September 19, 2026 | Index ID: #-

Introduction

Advanced accounting is a pivotal subject for students and professionals who aspire to master the intricacies of corporate finance. Chapter 16, often titled “Consolidation and Equity Method,” challenges readers with complex scenarios that demand a deep understanding of financial reporting standards, intercompany transactions, and minority interests. In this comprehensive guide, we provide clear, step by step answers to the most common problems found in Chapter 16, ensuring you grasp the underlying concepts and can apply them confidently in both academic and real world settings.

Overview of Chapter 16 Advanced Accounting

Chapter 16 delves into the mechanics of consolidating financial statements, handling variable interest entities (VIEs), and applying the equity method for investments in associates. It covers:

- Consolidation procedures and the elimination of intercompany balances.
- Recognition of non controlling interests.
- Variable interest entity analysis under ASC 810.
- Equity method accounting for investments in associates and joint ventures.
- Adjustments for minority interests and the impact on earnings per share.

Mastering these topics requires not only memorizing formulas but also understanding how each transaction affects the financial statements.

Key Concepts Covered

Consolidation of Financial Statements

Consolidation combines the financial data of a parent company and its subsidiaries into a single set of statements. The process eliminates intercompany transactions and balances to avoid double counting.

Intercompany Transactions

These are sales, purchases, loans, or dividends between entities within the same corporate group. Proper elimination ensures that the group’s financial position reflects only external interactions.

Variable Interest Entities (VIEs)

VIEs are entities where the primary beneficiary holds a variable interest that could influence the entity’s financial performance. ASC 810 provides criteria to determine if consolidation is required.

Equity Method for Associates

When a company owns 20%–50% of another entity’s voting stock, it applies the equity method, recognizing its share of the associate’s earnings and adjusting the carrying amount of the investment.

Minority Interest

Also known as non controlling interest, it represents the portion of a subsidiary’s equity not owned by the parent. Accurate measurement is essential for proper reporting of consolidated equity and earnings per share.

Common Topics

- Elimination of intercompany receivables and payables.
- Recording of intercompany profits and losses.
- Measurement of non controlling interest in the equity method.
- Adjustments for minority interest in the consolidated income statement.
- Handling of joint ventures and the application of the equity method.

Detailed Answers Section

Problem 1: Consolidation of Financial Statements

Scenario: Parent Company P owns 80% of Subsidiary S. P's purchase price included $50,000 in goodwill. S's assets and liabilities were recorded at fair value at the acquisition date.

Answer: The consolidation process requires elimination of P's investment in S and S's equity accounts. The steps are:

1. Eliminate Investment: Debit Investment in Subsidiary for $200,000 and credit Equity for the same amount.
2. Eliminate Subsidiary's Equity: Credit Common Stock and Retained Earnings for the amounts recorded by S.
3. Record Goodwill: Credit Goodwill for $50,000 and debit Investment in Subsidiary for the same.
4. Adjust for minority interest: Recognize 20% of S's equity as Non Controlling Interest.

These entries ensure that the consolidated statements reflect only the parent's and subsidiary's external activities.

Problem 2: Intercompany Transactions

Scenario: Company A sells inventory to Company B for $120,000, costing $80,000. The sale occurs before the consolidation date, and the inventory remains unsold at year end.

Answer: Intercompany profit of $40,000 must be eliminated. The journal entries are:

- Debit Intercompany Receivable $120,000; Credit Sales Revenue $120,000.
- Debit Cost of Goods Sold $80,000; Credit Inventory $80,000.

Elimination entries during consolidation:

- Debit Sales Revenue $120,000; Credit Intercompany Receivable $120,000.
- Debit Inventory $40,000; Credit Cost of Goods Sold $40,000.

Result: The $40,000 profit is removed from consolidated income and the inventory is adjusted to reflect the cost of $80,000.

Problem 3: Variable Interest Entities (VIEs)

Scenario: Company X holds a 30% equity interest in VIE Y and has the power to direct the activities that most significantly affect Y's economic performance.

Answer: Under ASC 810, X is the primary beneficiary and must consolidate Y. Key steps:

1. Identify the controlling interest based on the power to direct and the ability to absorb losses or earn benefits.
2. Prepare a consolidated balance sheet and income statement, eliminating all intercompany balances.
3. Recognize any minority interest if other parties hold significant interests.

Failure to consolidate a VIE can lead to understated assets and equity, misrepresenting the group's financial health.

Problem 4: Investment in Associates

Scenario: Company M owns 35% of Company N. N's net income for the year is $150,000. M also receives a dividend of $20,000 from N.

Answer: Apply the equity method:

- Recognize M's share of N's earnings: 35% × $150,000 = $52,500.
- Increase the carrying amount of the investment by $52,500.
- Record the dividend received as a reduction in the investment: Debit Cash $20,000; Credit Investment in Associate $20,000.
- Report $52,500 as income in M's income statement under "Share of Associate Earnings."

These entries ensure that M's financial statements reflect its proportional economic interest in N.

Problem 5: Minority Interest

Scenario: Company Q consolidates Subsidiary R, which has an equity of $500,000. Q owns 60% of R, and the remaining 40% is minority interest.

Answer: Calculate minority interest:

- Minority interest = 40% × $500,000 = $200,000.
- Record as a separate line item on the consolidated balance sheet under equity.
- In the income statement, allocate 40% of R's earnings to minority interest.

Accurate measurement ensures that earnings per share calculations reflect the parent's true ownership.

Problem 6: Shareholder Equity Adjustments

Scenario: Following consolidation, Company L's equity section shows a "Retained Earnings" balance that appears too high due to intercompany dividends.

Answer: Adjust retained earnings by eliminating intercompany dividends:

1. Debit Retained Earnings for the dividend amount.
2. Credit Dividends Payable to reverse the dividend recorded in the subsidiary.

These adjustments prevent double counting of dividend income.

Problem 7: Non Controlling Interest in Consolidated Statements

Scenario: Company G consolidates Company H, which has a minority interest of 25%. H's net income is $300,000.

Answer: Allocate net income:

- Company G's share: 75% × $300,000 = $225,000.
- Non controlling interest: 25% × $300,000 = $75,000.

Report $225,000 under "Net Income" and $75,000 under "Net Income attributable to Non Controlling Interest."

Problem 8: Joint Ventures

Scenario: Company D and Company E jointly own a venture, each holding 50%. The venture's net income is $200,000.

Answer: Apply the equity method:

- Company D's share: 50% × $200,000 = $100,000.

- Increase the investment account by $100,000.
- Record income in the income statement as “Share of Joint Venture Earnings.”

Unlike consolidation, joint ventures do not merge financial statements but reflect proportional earnings.

Problem 9: Consolidated Income Statement Adjustments

Scenario: After consolidating, the group’s income statement shows $400,000 in sales, but $50,000 of those sales were intercompany. The cost of goods sold includes $200,000, with $30,000 intercompany.

Answer: Eliminate intercompany sales and costs:

- Debit Sales Revenue $50,000; Credit Intercompany Receivables $50,000.
- Debit Cost of Goods Sold $30,000; Credit Intercompany Payables $30,000.

Resulting consolidated sales: $350,000; cost of goods sold: $170,000.

Problem 10: Equity Method Adjustments

Scenario: Company F owns 40% of Company G. G’s dividends for the year total $80,000. Company F also recognizes a $10,000 impairment on its investment.

Answer: Journal entries:

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