ADVANCED FINANCIAL ACCOUNTING

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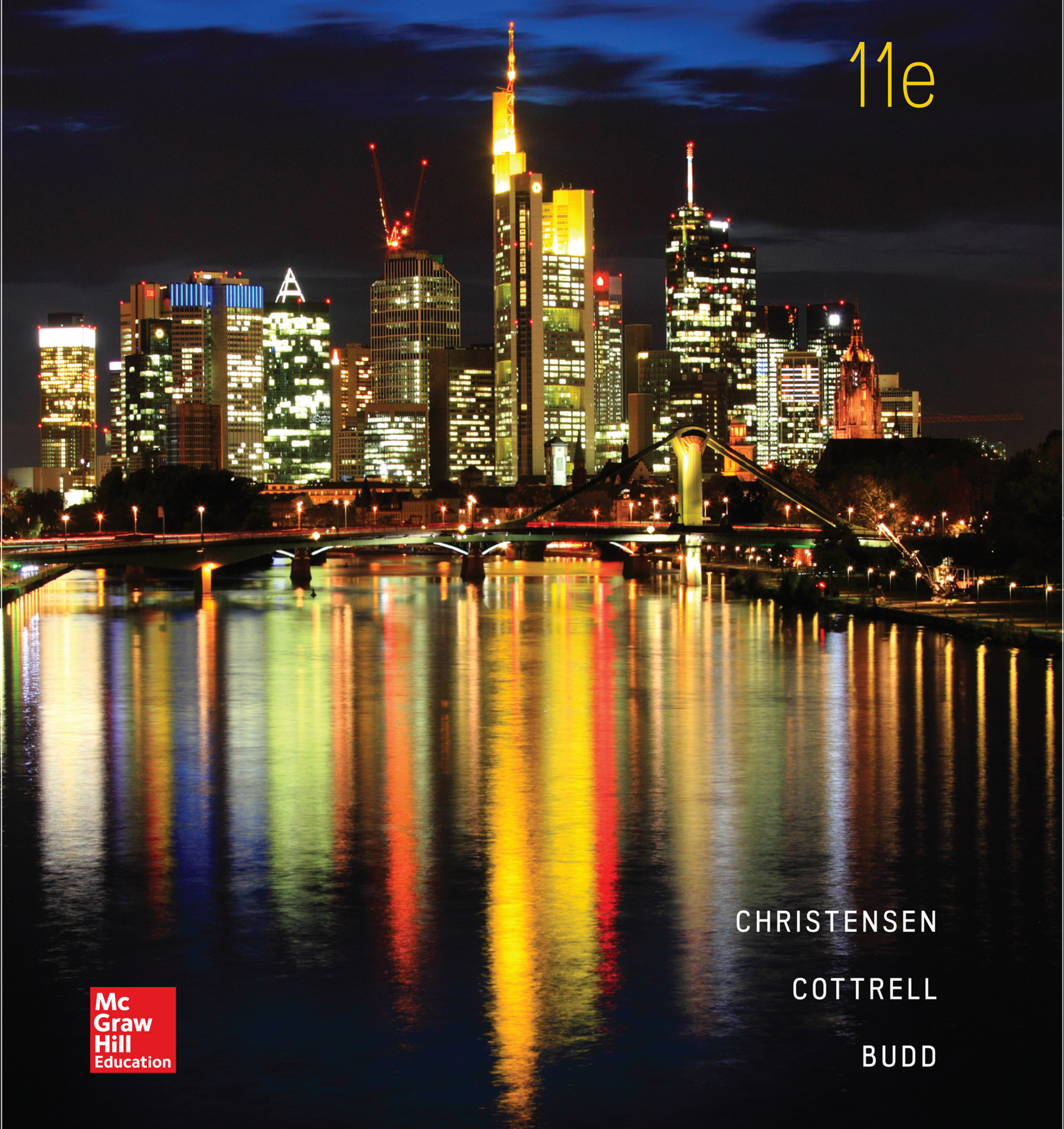

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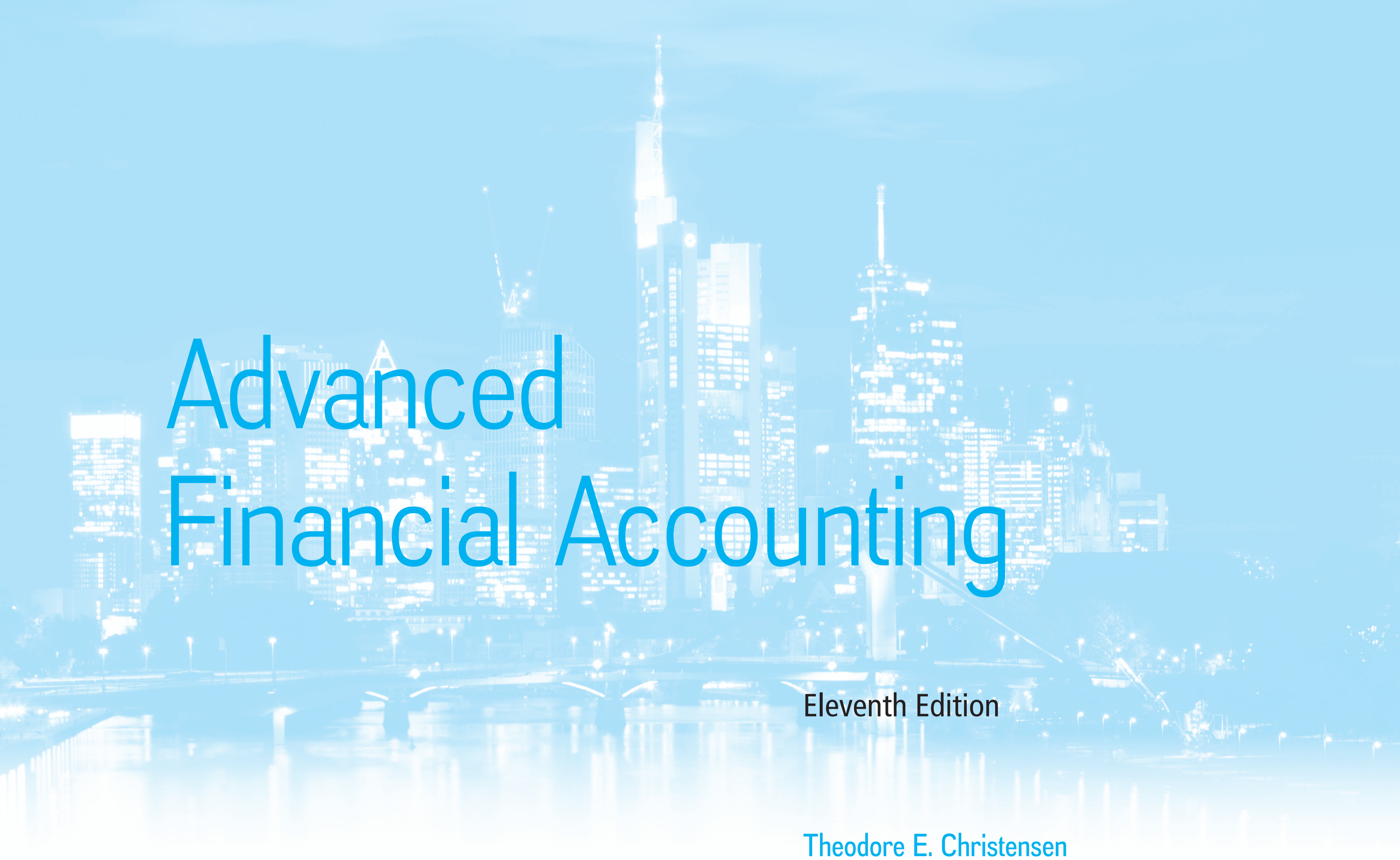

Advanced Financial Accounting

Eleventh Edition

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Brigham Young University

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Brigham Young University

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Brigham Young University

Mc Graw Hill Education

ADVANCED FINANCIAL ACCOUNTING, ELEVENTH EDITION

Published by McGraw-Hill Education, 2 Penn Plaza, New York, NY 10121.

This book is printed on acid-free paper.

1 2 3 4 5 6 7 8 9 0 DOW/DOW 1 0 9 8 7 6 5 4

ISBN 978-0-07-802587-7
MHID 0-07-802587-7

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Buyer: *Debra R. Sylvester*
Design: *Matt Diamond*
Cover Image: © *Krzysztof Baranowski/Getty Images*
Compositor: *Laserwords Private Limited*
Printer: *R. R. Donnelley*

Library of Congress Cataloging-in-Publication Data

Christensen, Theodore E.
Advanced financial accounting.—Eleventh edition / Theodore E. Christensen, David M. Cottrell, Cassy Budd.
pages cm
ISBN 978-0-07-802587-7 (alk. paper)
1. Accounting. I. Cottrell, David M. II. Budd, Cassy. III. Title.
HF5636.B348 2016
657'.046—dc23

2014026757

www.mhhe.com

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David M. Cottrell

Professor Cottrell joined the faculty at Brigham Young University in 1991. He currently serves as the Associate Director of the School of Accountancy. Prior to coming to BYU he spent five years at The Ohio State University, where he earned his PhD. Before pursuing a career in academics he worked as an auditor and consultant for the firm of Ernst & Young in its San Francisco office. At BYU, Professor Cottrell has developed and taught courses in the School of Accountancy, the MBA program, and the Finance program. He has won numerous awards from the alumni and faculty for his teaching and curriculum development. He has received the Outstanding Professor Award in the college of business as selected by the students in the Finance Society; he has received the Outstanding Teaching Award as selected by the Marriott School of Management; and he is a four-time winner of the collegewide Teaching Excellence Award for Management Skills, which is selected by the Alumni Board of the Marriott School of Management at BYU. Professor Cottrell also has authored many articles about accounting and auditing issues. His articles have been published in *Issues in Accounting Education, Journal of Accounting Case Research, Quarterly Review of Distance Education, Journal of Accountancy, The CPA Journal, Internal Auditor, The Tax Executive,* and *Journal of International Taxation,* among others.

Cassy JH Budd

Professor Budd has been a faculty member at Brigham Young University since 2005. Prior to coming to BYU, she was on the faculty at Utah State University for three years. She received a BS degree in accounting at Brigham Young University and a MAcc degree in tax at Utah State University. Before pursuing a career in academics she worked as an auditor for the firm of PricewaterhouseCoopers LLP in its Salt Lake, San Jose, and Phoenix offices and continues to maintain her CPA license. Professor Budd has taught financial accounting at all levels, introductory managerial accounting, undergraduate and graduate auditing, and partnership taxation. She is the recipient of numerous awards for teaching and student advisement, including the Dean Fairbanks Teaching and Learning Faculty Fellowship, Brigham Young University; School of Accountancy Advisor of the

Year, Utah State University; State of Utah Campus Compact Service-Learning Engaged Scholar Award, and the Joe Whitesides Scholar–Athlete Recognition Award from Utah State University. She has been active in serving on various committees of the American Accounting Association, including chairing the annual Conference on Teaching and Learning in Accounting.

Preface

The Eleventh Edition of *Advanced Financial Accounting* is an up-to-date, comprehensive, and highly illustrated presentation of the accounting and reporting principles and procedures used in a variety of business entities. Every day, the business press carries stories about the merger and acquisition mania, the complexities of modern business entities, new organizational structures for conducting business, accounting scandals related to complex business transactions, the foreign activities of multinational firms, the operations of governmental and not-for-profit entities, and bankruptcies of major firms. Accountants must understand and know how to deal with the accounting and reporting ramifications of these issues.

OVERVIEW

This edition continues to provide strong coverage of advanced accounting topics with clarity of presentation and integrated coverage based on continuous case examples. The text is complete with presentations of worksheets, schedules, and financial statements so students can see the development of each topic. Inclusion of all recent FASB and GASB pronouncements and the continuing deliberations of the authoritative bodies provide a current and contemporary text for students preparing for the CPA examination and current practice. This emphasis has become especially important given the recent rapid pace of the authoritative bodies in dealing with major issues having far-reaching implications. The Eleventh Edition covers the following topics:

Multicorporate Entities

Business Combinations

1 Intercorporate Acquisitions and Investments in Other Entities

Consolidation Concepts and Procedures

2 Reporting Intercorporate Investments and Consolidation of Wholly Owned Subsidiaries with No Differential
3 The Reporting Entity and the Consolidation of Less-than-Wholly-Owned Subsidiaries with No Differential
4 Consolidation of Wholly Owned Subsidiaries Acquired at More than Book Value
5 Consolidation of Less-than-Wholly-Owned Subsidiaries Acquired at More than Book Value

Intercompany Transfers

6 Intercompany Inventory Transactions
7 Intercompany Transfers of Services and Noncurrent Assets
8 Intercompany Indebtedness

Additional Consolidation Issues

9 Consolidation Ownership Issues
10 Additional Consolidation Reporting Issues

Multinational Entities

Foreign Currency Transactions

11 Multinational Accounting: Foreign Currency Transactions and Financial Instruments

Translation of Foreign Statements

12 Multinational Accounting: Issues in Financial Reporting and Translation of Foreign Entity Statements

Reporting Requirements

Segment and Interim Reporting

13 Segment and Interim Reporting

SEC Reporting

14 SEC Reporting

Partnerships

Formation, Operation, Changes

15 Partnerships: Formation, Operation, and Changes in Membership

Liquidation

16 Partnerships: Liquidation

Governmental and Not-for-Profit Entities

Governmental Entities

17 Governmental Entities: Introduction and General Fund Accounting

Special Funds

18 Governmental Entities: Special Funds and Governmentwide Financial Statements

Not-for-Profit

19 Not-for-Profit Entities

Corporations in Financial Difficulty

20 Corporations in Financial Difficulty

NEW FEATURES ADDED IN THE ELEVENTH EDITION

- **Deferred tax coverage.** We have made extensive revisions to Chapter 10 to add more coverage of the deferred tax implications associated with business combinations, including the allocation of deferred taxes related to the book-tax basis differences of acquired assets.
- **New shading of consolidation worksheet entries.** Based on the new two-color shading introduced in the Eleventh Edition, we have revised the shading of consolidation worksheet entries to clearly distinguish between the various types of entries. We have extended this shading not only to the worksheets but also to supporting schedules and calculation boxes so that numbers appearing in consolidation worksheet entries are uniformly shaded in all locations.
- **Presentation of intercompany transactions.** We have significantly revised the three chapters related to intercompany transactions. Based on feedback from instructors, we have revised Chapters 6, 7, and 8 by adding illustrations to better simplify adjustments to the basic consolidation entry.

KEY FEATURES MAINTAINED IN THE ELEVENTH EDITION

The key strengths of this text are the clear and readable discussions of concepts and their detailed demonstrations through illustrations and explanations. The many favorable responses to prior editions from both students and instructors confirm our belief that clear presentation and comprehensive illustrations are essential to learning the sophisticated topics in an advanced accounting course. Key features maintained in the Eleventh Edition include:

- **Callout boxes.** We have updated the “callout boxes” that appear in the left-hand margin to draw attention to important points throughout the chapters. The most common callout boxes are the “FYI” boxes, which often illustrate how real-world companies or entities apply the principles discussed in the various chapters. The “Caution” boxes draw students’ attention to common mistakes and explain how to avoid them. The “Stop & Think” boxes help students take a step back and think through the logic of difficult concepts.
- **FASB codification.** All authoritative citations to U.S. GAAP are now exclusively cited based on the FASB codification.
- **Introductory vignettes.** Each chapter begins with a brief story of a well-known company to illustrate why topics covered in that chapter are relevant in current practice.

Short descriptions of the vignettes and the featured companies are included in the Chapter-by-Chapter Changes section on page xvii.

- **A building-block approach to consolidation.** Virtually all advanced financial accounting classes cover consolidation topics. Although this topic is perhaps the most important to instructors, students frequently struggle to gain a firm grasp of consolidation principles. The Eleventh Edition provides students a learning-friendly framework to consolidations by introducing consolidation concepts and procedures more gradually. This is accomplished by a building-block approach that introduces consolidations in Chapters 2 and 3 and continues through chapter 5.
- **IFRS comparisons.** As the FASB and IASB work toward convergence to a single set of global accounting standards, the SEC is debating the wholesale introduction of international financial reporting standards (IFRS). The Eleventh Edition summarizes key differences between current U.S. GAAP and IFRS to make students aware of changes that will likely occur if the SEC adopts IFRS in the near future.
- **AdvancedStudyGuide.com.** See page xv for details.
- **The use of a continuous case for each major subject-matter area.** This textbook presents the complete story of a company, Peerless Products Corporation, from its beginning through its growth to a multinational consolidated entity and finally to its end. At each stage of the entity's development, including the acquisition of a subsidiary, Special Foods Inc., the text presents comprehensive examples and discussions of the accounting and financial reporting issues that accountants face. The discussions tied to the Peerless Products continuous case are easily identified by the company logos in the margin:

  Peerless Products Corporation   Special Foods Inc.

  We use the comprehensive case of Peerless Products Corporation and its subsidiary, Special Foods Inc., throughout the for-profit chapters. For the governmental chapters, the Sol City case facilitates the development of governmental accounting and reporting concepts and procedures. Using a continuous case provides several benefits. First, students need become familiar with only one set of data and can then move more quickly through the subsequent discussion and illustrations without having to absorb a new set of data. Second, the case adds realism to the study of advanced accounting and permits students to see the effects of each successive step on an entity's financial reports. Finally, comparing and contrasting alternative methods using a continuous case allows students to evaluate different methods and outcomes more readily.
- **Extensive illustrations of key concepts.** The book is heavily illustrated with complete, not partial, workpapers, financial statements, and other computations and comparisons useful for demonstrating each topic. The illustrations are cross-referenced to the relevant text discussion. In the consolidations portion of the text, the focus is on the fully adjusted equity method of accounting for an investment in a subsidiary, but two other methods—the cost method and the modified equity method—are also discussed and illustrated in chapter appendixes.
- **Comprehensive coverage with significant flexibility.** The subject matter of advanced accounting is expanding at an unprecedented rate. New topics are being added, and traditional topics require more extensive coverage. Flexibility is therefore essential in an advanced accounting text. Most one-term courses are unable to cover all topics included in this text. In recognition of time constraints, this text is structured to provide the most efficient use of the time available. The self-contained units of subject matter allow for substantial flexibility in sequencing the course materials. In addition, individual chapters are organized to allow for going into more depth on some topics

through the use of the "Additional Considerations" sections. Several chapters include appendixes containing discussions of alternative accounting procedures or illustrations of procedures or concepts that are of a supplemental nature.

- **Extensive end-of-chapter materials.** A large number of questions, cases, exercises, and problems at the end of each chapter provide the opportunity to solidify understanding of the chapter material and assess mastery of the subject matter. The end-of-chapter materials progress from simple focused exercises to more complex integrated problems. Cases provide opportunities for extending thought, gaining exposure to different sources of accounting-related information, and applying the course material to real-world situations. These cases include research cases that refer students to authoritative pronouncements and Kaplan CPA Review simulations. The American Institute of CPAs has identified five skills to be examined as part of the CPA exam: (*a*) analysis, (*b*) judgment, (*c*) communication, (*d*) research, and (*e*) understanding. The end-of-chapter materials provide abundant opportunities for students to enhance those skills with realistic and real-world applications of advanced financial accounting topics. Cases and exercises identified with a world globe icon provide special opportunities for students to access real-world data by using electronic databases, Internet search engines, or other inquiry processes to answer the questions presented on the topics in the chapters.

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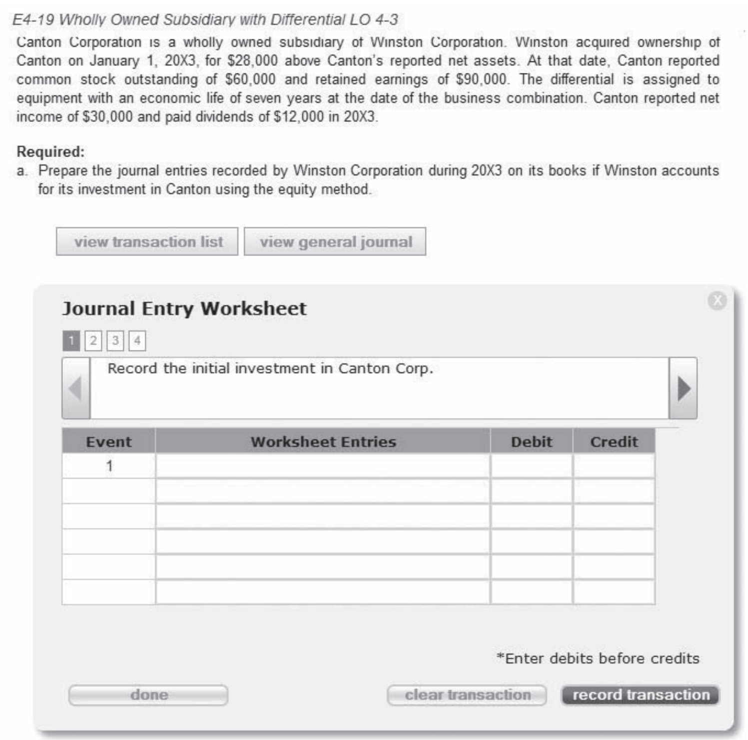
McGraw-Hill *Connect Accounting* is a digital teaching and learning environment that gives students the means to better connect with their coursework, with their instructors, and with the important concepts that they will need to know for success now and in the future. With *Connect Accounting,* instructors can deliver assignments, quizzes,



and tests easily online. Students can review course material and practice important skills. *Connect Accounting* provides the following features:

- SmartBook and LearnSmart.
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For more information about *Connect Accounting,* go to **www.connect.mheducation.com,** or contact your local McGraw-Hill Higher Education representative.

SmartBook, powered by LearnSmart

LearnSmart™ is the market-leading adaptive study resource that is proven to strengthen memory recall, increase class retention, and boost grades. LearnSmart allows students to study more efficiently because they are made aware of what they know and don't know.

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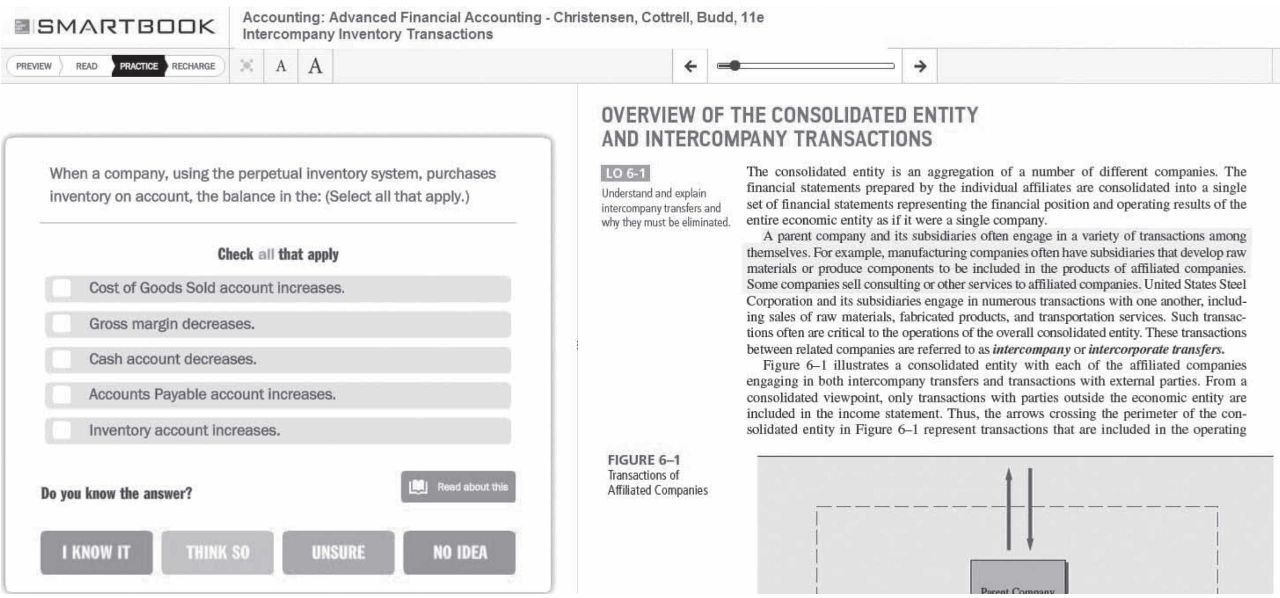

Online Assignments

Connect Accounting helps students learn more efficiently by providing feedback and practice material when they need it, where they need it. *Connect* grades homework automatically and gives immediate feedback on any questions students may have missed. Our assignable, gradable end-of-chapter content includes a general journal application that looks and feels more like what you would find in a general ledger software package. Also, select questions have been redesigned to test students' knowledge more fully. They now include tables for students to work through rather than requiring that all calculations be done offline.

MCGRAW-HILL *CONNECT ACCOUNTING* FEATURES

Connect Accounting offers powerful tools, resources, and features to make managing assignments easier so faculty can spend more time teaching.

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- Create and deliver assignments easily with selectable end-of-chapter questions and test bank items.
- Use algorithmically generated numbers for selected problems. This feature allows each student to complete an individualized problem with customized explanations of each calculation.
- Have assignments scored automatically, giving students immediate feedback on their work and side-by-side comparisons with correct answers.
- Access and review each response; manually change grades or leave comments for students to review.
- Reinforce classroom concepts with practice assignments, instant quizzes, and exams.

Powerful Instructor and Student Reports

Connect Accounting keeps instructors informed about how each student, section, and class is performing, allowing for more productive use of lecture and office hours. The progress-tracking function enables you to

- View scored work immediately and track individual or group performance with assignment and grade reports.
- Access an instant view of student or class performance relative to learning objectives.
- Collect data and generate reports required by many accreditation organizations, such as AACSB and AICPA.

Instructor Library

The *Connect Accounting* Instructor Library is your repository for additional resources to improve student engagement in and out of class. You can select and use any asset that enhances your lecture. The *Connect Accounting* Instructor Library also allows you to upload your own files. The Instructor Library includes

- eBook
- Solutions Manual
- Instructor's Manual
- Instructor PowerPoint® Presentations
- Test Bank

Student Resource Library

The *Connect Accounting* Student Resources give students access to additional resources such as recorded lectures, online practice materials, an eBook, and more.

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The first and only analytics tool of its kind, Connect Insight™ is a series of visual data displays—each framed by an intuitive question—to provide at-a-glance information regarding how your class is doing.

Connect Insight provides a quick analysis on five key insights, available at a moment's notice from your tablet device:

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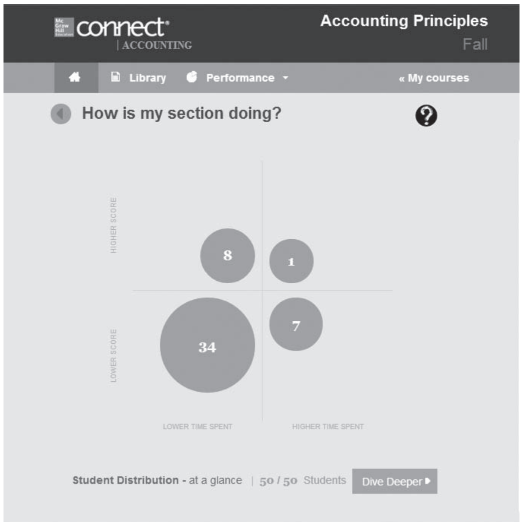
3. How is this student doing?
4. How are my assignments doing?
5. How is this assignment going?



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Tegrity Campus® is a service that makes class time available 24/7 by automatically capturing every lecture. With a simple one-click start-and-stop process, you capture all computer screens and corresponding audio in a format that is easily searchable, frame by frame. Students can replay any part of any class with easy-to-use browser-based viewing on a PC, Mac, or mobile device.

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EZ TEST ONLINE

The comprehensive test bank includes both conceptual and procedural exercises, problems, multiple-choice, and matching questions. Each test item is tagged by learning objective; topic area; difficulty level; and AACSB, Bloom's, and AICPA categories.

McGraw-Hill's EZ Test Online is a flexible and easy-to-use electronic testing program that allows instructors to create tests from book-specific items. EZ Test Online accommodates a wide range of question types and allows instructors to add their own questions. Multiple versions of the test can be created and any test can be exported for use with course management systems such as BlackBoard/WebCT. EZ Test Online gives instructors a place to easily administer exams and quizzes online. The program is available for Windows and Mac environments.

ASSURANCE OF LEARNING READY

Many educational institutions today focus on the notion of *assurance of learning,* an important element of some accreditation standards. *Advanced Financial Accounting* is designed specifically to support your assurance of learning initiatives with a simple yet powerful solution.

Each test bank question for *Advanced Financial Accounting* maps to a specific chapter learning outcome/objective listed in the text. You can use our test bank software, EZ Test and EZ Test Online, or McGraw-Hill's *Connect Accounting* to easily query for learning outcomes/objectives that directly relate to the learning objectives for your course. You can then use the reporting features of EZ Test to aggregate student results in a similar fashion, making the collection and presentation of assurance of learning data simple and easy.

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AACSB STATEMENT

The McGraw-Hill Companies is a proud corporate member of AACSB International. Understanding the importance and value of AACSB accreditation, *Advanced Financial Accounting* Eleventh Edition recognizes the curricula guidelines detailed in the AACSB standards for business accreditation by connecting selected questions in the text and the test bank to the six general knowledge and skill guidelines in the AACSB standards.

The statements contained in *Advanced Financial Accounting* Eleventh Edition are provided only as a guide for the users of this textbook. The AACSB leaves content coverage and assessment within the purview of individual schools, the mission of the school, and the faculty. Although *Advanced Financial Accounting* Eleventh Edition and the teaching package make no claim of any specific AACSB qualification or evaluation, we have within *Advanced Financial Accounting* Eleventh Edition labeled selected questions according to the six general knowledge and skills areas.

HIGH TECH: THE ELEVENTH EDITION ADDS KEY TECHNOLOGY RESOURCES TO BENEFIT BOTH STUDENTS AND INSTRUCTORS

Advanced StudyGuide .com

The Eleventh Edition of *Advanced Financial Accounting* introduces the most cutting-edge technology supplement ever delivered in the advanced accounting market. AdvancedStudyGuide.com is a product created exclusively by the text authors that represents a new generation in study resources available to students as well as a new direction and options in the resources instructors can use to help their students and elevate their classroom experiences.

Traditional study guides offer students a resource similar to the text itself—that is, more discussion like the text accompanied by more problems and exercises like the ones in the text at a fairly high price to give students the same type of materials that have they already received with the text.

At its core, **AdvancedStudyGuide.com** (ASG) offers materials that go beyond what a printed text can possibly deliver. The ASG contains dozens of narrated, animated discussions and explanations of materials aligned to key points in the chapter. Not only that, the ASG also contains animated problems just like key problems in the exercises and problems at the end of each chapter. For the student who would like a little help with *Advanced Financial Accounting,* the ASG is like having private tutoring sessions from the authors who wrote the book (not a class TA) any time, day or night. This also can provide tremendous benefits for instructors, as outlined below.

For Students

The Questions

- Have you ever had to miss a class and were then confused about what the book was trying to say about a topic?
- Even when you were in class, do things sometimes not make as much sense when you are reviewing on your own?
- Do you ever feel stuck when it comes to doing homework problems even though you read the chapter?
- When the exam is a few weeks after you covered the material in class, do you ever wish someone could walk you through a few examples as you review for the exam?
- Have you ever purchased a study guide for a text and found it was very expensive and did not give the additional study help you needed?

The ASG Answer

- The answer, at least in part, is the ASG: a new type of study guide designed for the way you like to study and the way that you learn best.
- It is our attempt as authors to really discuss the material in a way that a text-only approach cannot do.
- AND we can discuss your questions with you 24/7, anytime—day or night, at times when your regular instructor is not around.
- Through the ASG, we will bring you streaming media discussions by the authors of the book (not a class TA) to explain key points of each chapter.
- The ASG will also show, explain, and illustrate for you the approach to solving key homework problems in the text. These explanations are ***Like Problems*;** that is, they are problems "just like" some in the text that you were assigned for homework.

The ASG Benefit

AdvancedStudyGuide.com brings you discussion and examples worked out in streaming video. Although traditional study guides can ***Tell*** you what to do, the ASG will ***Show You What to Do AND HOW to Do It.***

See the student page at AdvancedStudyGuide.com.

For Instructors

The Questions

- Have you ever had a student miss class and then come to your office and ask you to go over the topics that were discussed in class the day the student was absent?
- Even when a student is in class, does he or she sometimes come to your office and ask you to repeat the discussion?
- Even when you have discussed the chapter concepts, do you have students who still get stuck when it comes to doing homework problems?
- When exams are approaching, do students sometimes ask you to go back over material you taught days or weeks before?
- Would it be helpful to you if, on occasion, the authors of the text offered to hold "office hours" with your students for you?

The ASG Answer

- The answer, at least in part, is the ASG: the authors' attempt to partner with you in helping to better serve students' needs in some of the common situations where questions arise, without using more of your scarce time.
- The ASG will allow you to refer to streaming media discussions where the authors explain key points of each chapter.

- The ASG will show, explain, and illustrate for students the approach to solving key homework problems in the text. These explanations are ***Like Problems***; that is they are problems "just like" some in the text that you can assign for homework.

The ASG Benefit

AdvancedStudyGuide.com is a great tool to let the authors of the text partner with you, the instructor, in helping students learn *Advanced Financial Accounting.* The ASG will (1) help your students learn more effectively, (2) improve your class discussions, and (3) make your student contact hours more efficient.

See the instructor page at AdvancedStudyGuide.com.

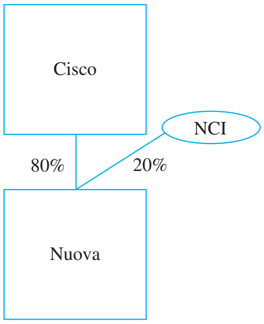
CHAPTER-BY-CHAPTER CHANGES

- **Chapter 1** emphasizes the importance of business acquisitions and combinations. The chapter has been significantly reorganized and updated based on feedback from textbook adopters to provide a clearer and more concise discussion of the accounting treatment of mergers, acquisitions, and other intercorporate investments. We have added new illustrations and updated the beginning-of-chapter vignette and callout boxes to provide real-world examples of the topics discussed in the chapter, most of which provide additional information about the **Kraft Foods Inc.** example in the introductory vignette.

- **Chapter 2** summarizes the different types of intercorporate investments and introduces consolidation in the most straightforward scenario—where the parent company acquires full ownership of the subsidiary for an amount equal to the subsidiary's book value (i.e., no differential). Based on the new two-color shading introduced in the Eleventh Edition, this chapter introduces a new method of shading our consolidation worksheet entries to make them easily distinguishable by the reader. We have updated this chapter to provide a more streamlined and understandable coverage of topics traditionally included in this chapter. Finally, we have updated the "callout boxes" that provide real-world examples of the topics discussed in the chapter, some of which provide additional information about **Berkshire Hathaway's** investments discussed in the introductory vignette.

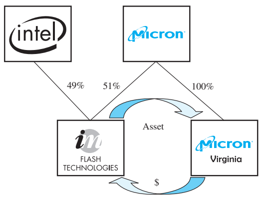
- **Chapter 3** explores how the basic consolidation process differs when a subsidiary is only partially owned. Moreover, it introduces the notion of special-purpose entities and accounting standards related to variable interest entities by discussing the well-known collapse of **Enron Corporation.** We have streamlined and shortened this chapter based on feedback from adopters to provide a better flow for the material. In addition, we have updated the callout boxes to help students understand the intricacies associated with the consolidation of a partially owned subsidiary and dealing with variable interest entities.

- **Chapter 4** gives a behind-the-scenes look at the work that goes into the consolidation process based on **Disney Corporation.** This chapter introduces consolidation of wholly owned subsidiaries with a differential, which results in situations in which the acquiring company pays more than the book value of the acquired company's net assets. This chapter adds a detailed explanation of the new shading of the consolidation worksheet entries introduced in Chapter 2. Finally, we have added a new illustration based on Disney's recent acquisition of the rights to the well-known "Star Wars" films when it acquired Lucasfilm.



- **Chapter 5** discusses majority ownership of subsidiaries based on the 80 percent acquisition of **Nuova Systems** by **Cisco Systems Inc.** We further the discussion of acquisitions with a differential that has the added complexity of noncontrolling interest shareholders when they purchase less than 100 percent of the outstanding common stock. We have simplified the coverage of some of the topics in this chapter and removed tangential topics to provide more concise coverage of the important material.

- **Chapter 6** introduces intercompany inventory transfers based on **Samsung Electronics** and its subsidiaries. The elimination of intercompany profits can become complicated. In fact, intercompany inventory transactions and the consolidated procedures associated with them represent one of the topics textbook adopters have found most difficult to teach to students. As a result, we have rewritten this chapter extensively. We have added illustrations to better simplify adjustments to the basic consolidation entry and new graphics to illustrate difficult topics. In addition, we have added a series of new callout boxes to draw students' attention to the subtle complexities that our students have frequently struggled to understand.



- **Chapter 7** presents a real fixed asset transfer between two of **Micron's** subsidiaries. This chapter explores the accounting for both depreciable and nondepreciable asset transfers among affiliated companies. Continuing the coverage of intercompany transfers from Chapter 6, Chapter 7 is one of the most difficult to teach for many adopters. Therefore, we have spent considerable time revising this chapter. We have reorganized some of the material and have added illustrations to better simplify adjustments to the basic consolidation entry and new graphics to simplify difficult topics.

- **Chapter 8** explains how **Ford Motor Credit Company** was able to survive the economic turmoil of 2008–2009 by wisely using intercompany debt transactions to its advantage. Ford Motor Credit benefited by borrowing funds from its parent company rather than going directly to the capital markets. This chapter was the most extensively rewritten chapter in the Tenth Edition of the book. The original approach of introducing the accounting for debt transfers using the straight-line amortization of discounts and premiums was not representative of real-world accounting treatment. As a result, the Tenth Edition introduced the effective interest method and moved the majority of the original chapter (based on the straight-line method) to the appendix so that instructors can teach this chapter using whichever method they prefer. Based on feedback from adopters, we have made additional revisions in the Eleventh Edition to clarify the effective interest method approach.

BERKSHIRE HATHAWAY INC.

- **Chapter 9** resumes the discussion of **Berkshire Hathaway** to demonstrate that, in practice, ownership situations can be complex. The discussion here provides a basic understanding of some of the consolidation problems arising from complex situations commonly encountered in practice including but not limited to changes in the parent's ownership interest and multiple ownership levels. We have revised the chapter to simplify and clarify some of these complex transactions.

- **Chapter 10** uses the example of the rapid growth of **Google Inc.** to explore four additional issues related to consolidated financial statements: the consolidated statement of cash flows, consolidation following an interim acquisition, consolidated tax considerations, and consolidated earnings per share. We have made extensive revisions to add more coverage of the deferred tax implications associated with business combinations, including the allocation of deferred taxes related to the book-tax basis differences of acquired assets.

- **Chapter 11** focuses on foreign currency transactions, financial instruments, and the effects that changes in exchange rates can have on reported results. We provide real-world examples of the topics discussed in the chapter, including the introductory vignette about **Microsoft.** We have revised this chapter extensively based on feedback from adopters to simplify and clarify the illustrations related to the use of forward contracts as hedging instruments.

- **Chapter 12** resumes the discussion of international accounting by exploring **McDonald's** global empire and how differences in accounting standards across countries and jurisdictions can cause significant difficulties for multinational firms. We have made significant revisions based on feedback from students on how the material could be presented in a more straightforward and easy-to-understand manner.

- **Chapter 13** examines segment reporting. We have made minor revisions to more clearly discuss the accounting standards for reporting an entity's operating components, foreign operations, and major customers and have updated the callout boxes illustrating how real companies, including **Walmart** from the introductory vignette, deal with segment reporting issues.

- **Chapter 14** reviews the complex role of the **Securities and Exchange Commission** to regulate trades of securities and to determine the type of financial disclosures that a publicly held company must make. We have made light revisions to update the coverage of recent laws and regulations.

- **Chapter 15** uses the example of **PricewaterhouseCoopers** to summarize the evolution of the original Big 8 accounting firms to today's Big 4 with an emphasis on partnerships. This chapter focuses on the formation and operation of partnerships, including accounting for the addition of new partners and the retirement of a present partner. We have made light revisions to the chapter to better explain partnership accounting.

- **Chapter 16** illustrates the dissolution of partnerships with the example of **Laventhol & Horwath,** the seventh-largest accounting firm in 1990. We have made light revisions to clarify some of the more difficult concepts related to partnership liquidation.

- **Chapter 17** introduces the topic of accounting for governmental entities. The chapter has two parts: the accounting and reporting requirements for state and local governmental units and a comprehensive illustration of accounting for a city's general fund. We have made light revisions to better explain some topics that students have found to be most difficult. Moreover, we have updated the callout boxes (most of which highlight specific examples related to the introductory vignette about **San Diego, California**) to clarify various topics.

- **Chapter 18** resumes the discussion of accounting for governmental entities by specifically examining special funds and governmentwide financial statements. We have lightly revised the chapter topics that are often misunderstood by students and have updated the callout boxes (which highlight specific examples related to the introductory vignette about the state of **Maryland**). Moreover, we have added some additional details related to more recent GASB pronouncements that were not included in the last edition.

- **Chapter 19** introduces accounting for not-for-profit entities using the example of **United Way Worldwide,** the largest charitable organization in the United States. We present the accounting and financial reporting principles used by both governmental and nongovernmental colleges and universities, health care providers, voluntary health and welfare organizations, and other not-for-profit organizations such as professional and fraternal associations. We have made light revisions and updated the callout boxes illustrating the real-world application of topics discussed in the chapter by well-known not-for-profit entities.

- **Chapter 20** introduces our final topic of corporations in financial difficulty by illustrating **General Motors Corporation** and its Chapter 11 bankruptcy protection granted in 2009. GM's experience illustrates that dealing with financial difficulty can be a long and complicated process, especially for large corporations. We present the range of major actions typically used by such a company. We have made minor revisions to the chapter content and have updated the callout boxes to highlight recent well-publicized bankruptcies.

Acknowledgments

This text includes the thoughts and contributions of many individuals, and we wish to express our sincere appreciation to them. First and foremost, we thank all the students in our advanced accounting classes from whom we have learned so much. In many respects, this text is an outcome of the learning experiences we have shared with our students. Second, we wish to thank the many outstanding teachers we have had in our own educational programs from whom we learned the joy of learning. We are indebted to our colleagues in advanced accounting for helping us reach our goal of writing the best possible advanced financial accounting text. We appreciate the many valuable comments and suggestions from the faculty who used recent editions of the text. Their comments and suggestions have contributed to making this text a more effective learning tool. We especially wish to thank Lauren Materne and James Shinners from the University of Michigan, Melissa Larson from Brigham Young University, and Sheldon Smith from Utah Valley State University.

We express our sincere thanks to the following individuals who provided reviews on the previous editions:

Andrea Astill
Indiana University–Bloomington

Jason Bergner
University of Central Missouri

Fatma Cebenoyan
Hunter College

Bobbie Daniels
Jackson State University

Carlos Diaz
Johnson & Wales University

David Doyon
Southern New Hampshire University

Cobby Harmon
University of California–Santa Barbara

Mark Holtzman
Seton Hall University

Charles Lewis
University of Houston–Downtown

Stephani Mason
Hunter College

Mallory McWilliams
University of California–Santa Cruz

Barbara Reeves
Cleary University

Sara Reiter
Binghamton University

Tom Rosengarth
Bridgewater College

Chantal Rowat
Bentley University

Mike Slaubaugh
Indiana University-Purdue University–Fort Wayne

Hannah Wong
William Paterson University

We are grateful for the assistance and direction of the McGraw-Hill team: Tim Vertovec, James Heine, Kathleen Klehr, Danielle Andries, Dana Pauley, Matt Diamond, Brian Nacik, Debra Sylvester, and Alpana Jolly, who all worked hard to champion our book through the production process.

We have permission from the Institute of Certified Management Accountants of the Institute of Management Accountants to use questions and/or unofficial answers from past CMA examinations. We appreciate the cooperation of the American Institute of Certified Public Accountants for providing permission to adapt and use materials from past Uniform CPA Examinations. And we thank Kaplan CPA Review for providing its online framework for *Advanced Financial Accounting* students to gain important experience with the types of simulations that are included on the Uniform CPA Examination.

Above all, we extend our deepest appreciation to our families who continue to provide the encouragement and support necessary for this project.

Theodore E. Christensen
David M. Cottrell
Cassy JH Budd

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KRAFT'S ACQUISITION OF CADBURY

In recent years, as well as during the past several decades, the business world has witnessed many corporate acquisitions and combinations, often involving some of the world's largest and best-known companies. Some of these combinations have captured public attention because of the personalities involved, the daring strategies employed, and the huge sums of money at stake. On February 2, 2010, Kraft Foods Inc. finalized a deal to *acquire* Cadbury PLC for \$18.5 billion, forming the second-largest confectionery, food, and beverage company in the world. At the time of the acquisition, Cadbury's net assets were worth only around \$4.6 billion. This highly visible transaction was merely the next step in more than a century of regular acquisitions.

In 1903, James L. Kraft started selling cheese door to door from the back of a horse-drawn wagon. Although not immediately successful, he continued operations and was eventually joined by four of his brothers in 1909. By 1914, Kraft & Bros. Company (later Kraft Foods Inc.) had opened its first cheese manufacturing plant and, in 1916, patented a new process for pasteurizing cheese, making the cheese resistant to spoilage and allowing it to be transported over long distances. In 1937, Kraft launched its well-known macaroni and cheese dinners.

Philip Morris acquired General Foods in 1985 and Kraft in 1988. A year later, General Foods and Kraft were *merged* to form Kraft General Foods Inc., which was renamed Kraft Foods Inc. in 1995. In 2000, Philip Morris acquired Nabisco Holdings and began integrating Nabisco and Kraft. In August 2008, the Post Cereal portion of Kraft was *split off* and *merged* with Ralcorp Holdings. The remaining portion of Kraft Foods Inc. is the company that took part in the 2010 acquisition of Cadbury PLC. Of course, this is only half of the story as Cadbury's history includes a unique journey as well. It took 104 years and dozens of *mergers* and *acquisitions* for Cadbury to grow into the company acquired by Kraft in 2010.

In August 2012, a mere two and a half years after acquiring Cadbury, Kraft's board of directors approved a *spin-off* of several of its businesses, including Cadbury. This *spin-off* would separate the high-growth global snack business from the North American grocery business (\$18 billion in annual sales), which is focused in more mature markets. Analysts predicted that this *spin-off* would allow Kraft to separate two very distinct businesses that face different opportunities and challenges.

Accordingly, Kraft Foods Inc. was *split* into two separate companies, Kraft Foods Group and Mondelēz International on October 1, 2012. The Kraft Foods Group includes the U.S. and Canadian grocery operations of the Kraft food family including brands like Cheez Whiz, Cool Whip, Jell-O, Kraft Macaroni & Cheese, Oscar Mayer, and Velveeta. Mondelēz International includes brands such as Cadbury, Chips Ahoy!, Nabisco, Oreo, Tang, Teddy Grahams, and Wheat Thins. Mondelēz includes nine brands that generate over \$1 billion in revenue annually and Kraft Foods includes 10 brands with over \$500 million in annual revenue. With the *division* into two companies complete, each can now focus on its own distinct strategies. For example on July 1, 2013, Kraft Food Groups *created* two new business units, a meals and desserts unit and an enhancers and snack nuts unit.

The business world is complex and frequent business combinations will continue to increase the complex nature of the business environment in the future. An understanding of the accounting treatment of mergers, acquisitions, and other intercorporate investments is an invaluable asset in our ever-changing markets. This chapter introduces the key concepts associated with business combinations.

LEARNING OBJECTIVES

When you finish studying this chapter, you should be able to:

LO 1-1 Understand and explain the reasons for and different methods of business expansion, the types of organizational structures, and the types of acquisitions.

LO 1-2 Understand the development of standards related to acquisition accounting over time.

LO 1-3 Make calculations and prepare journal entries for the creation of a business entity.

LO 1-4 Understand and explain the differences between different forms of business combinations.

LO 1-5 Make calculations and business combination journal entries in the presence of a differential, goodwill, or a bargain purchase element.

LO 1-6 Understand additional considerations associated with business combinations.

AN INTRODUCTION TO COMPLEX BUSINESS STRUCTURES

LO 1-1

Understand and explain the reasons for and different methods of business expansion, the types of organizational structures, and the types of acquisitions.

The business environment in the United States is perhaps the most dynamic and vibrant in the world, characterized by rapid change and exceptional complexity. In this environment, regulators and standard setters such as the Securities and Exchange Commission (SEC), the Financial Accounting Standards Board (FASB), and the Public Company Accounting Oversight Board (PCAOB) are scrambling to respond to the rapid-paced changes in a manner that ensures the continued usefulness of accounting reports to reflect economic reality. A number of accounting and reporting issues arise when two or more companies join under common ownership or a company creates a complex organizational structure involving new financing or operating entities. The first 10 chapters of this text focus on a number of these issues. Chapter 1 lays the foundation by describing some of the factors that have led to corporate expansion and some of the types of complex organizational structures and relationships that have evolved. Then it describes the accounting and reporting issues related to formal business combinations. Chapter 2 focuses on investments in the common stock of other companies. It also introduces basic concepts associated with the preparation of ***consolidated financial statements*** that portray the related companies as if they were actually a single entity. The next eight chapters systematically explain additional details related to the preparation and use of consolidated financial statements.

Enterprise Expansion

Most business enterprises seek to expand over time in order to survive and become profitable. Both the owners and managers of a business enterprise have an interest in seeing a company grow in size. Increased size often allows economies of scale in both production and distribution. By expanding into new markets or acquiring other companies already in those markets, companies can develop new earning potential and those in cyclical industries can add greater stability to earnings through diversification. For example, in 1997, Boeing, a company very strong in commercial aviation, acquired McDonnell Douglas, a company weak in commercial aviation but very strong in military aviation and other defense and space applications. In the early 2000s when orders for commercial airliners plummeted following a precipitous decline in air travel, increased defense spending helped level out Boeing's earnings.

Business Objectives

Complex organizational structures often evolve to help achieve a business's objectives, such as increasing profitability or reducing risk. For example, many companies establish subsidiaries to conduct certain business activities. A ***subsidiary*** is a corporation that another corporation, referred to as a ***parent company,*** controls, usually through majority ownership of its common stock. Because a subsidiary is a separate legal entity, the parent's risk associated with the subsidiary's activities is limited. There are many reasons for creating or acquiring a subsidiary. For example, companies often transfer their receivables to subsidiaries or special-purpose entities that use the receivables as collateral for bonds issued to other entities (securitization). External parties may hold partial or complete ownership of those entities, allowing the transferring company (i.e., the parent that originally held the receivables) to share its risk associated with the receivables. In some situations, companies can realize tax benefits by conducting certain activities through a separate entity. Bank of America, for example, established a subsidiary to which it transferred bank-originated loans and was able to save $418 million in quarterly taxes.[1]

Frequency of Business Combinations

Very few major companies function as single legal entities in our modern business environment. Virtually all major companies have at least one subsidiary, with more than a few broadly diversified companies having several hundred subsidiaries. In some cases, subsidiaries are created internally to separately incorporate part of the ongoing operations previously conducted within the parent company. Other subsidiaries are acquired externally through business combinations.

Business combinations are a continuing and frequent part of the business environment. For example, a merger boom occurred in the 1960s. This period was characterized by frantic and, in some cases, disorganized merger binges, resulting in creation of a large number of conglomerates, or companies operating in many different industries. Because many of the resulting companies lacked coherence in their operations, they often were less successful than anticipated, and many of the acquisitions of the 1960s have since been sold or abandoned. In the 1980s, the number of business combinations again increased. That period saw many leveraged buyouts or LBOs (when an acquiring company borrows the funds to buy another company), but the resulting debt plagued many of those companies for many years.

Through much of the 1990s, merger activity was fueled by a new phenomenon, the use of *private equity* money. Rather than the traditional merger activity that typically involves one publicly held company acquiring another, groups of investors—such as wealthy individuals, pension and endowment funds, and mutual funds—pooled their money to make acquisitions. Most of these acquisitions did not result in lasting ownership relationships, with the private equity companies usually attempting to realize a return by selling their investments after a relatively short holding period.

The number of business combinations through the 1990s dwarfed previous merger booms, with all records for merger activity shattered. This pace continued into the new century, with a record-setting $3.3 trillion in deals closed in 2000.[2] However, with the downturn in the economy in the early 2000s, the number of mergers declined significantly. Many companies put their expansion plans on hold, and a number of the mergers that did occur were aimed at survival.

[1] "PNC Shakes Up Banking Sector; Investors Exit," *The Wall Street Journal,* January 30, 2002, p. C2.

[2] Dennis K. Berman and Jason Singer, "Big Mergers Are Making a Comeback as Companies, Investors Seek Growth," *The Wall Street Journal,* November 5, 2005, p. A1.

Toward the middle of 2003, merger activity again increased and accelerated significantly through the middle of the decade. During one period of less than 100 hours in 2006, "around $110 billion in acquisition deals were sealed worldwide in sectors ranging from natural gas, to copper, to mouthwash to steel, linking investors and industrialists from India, to Canada, to Luxembourg to the U.S."[3]

This activity was slowed dramatically by the credit crunch of 2007–2008. Nevertheless, business combinations have increased dramatically in the postcrisis period and will continue to be an important business activity into the foreseeable future.

Aside from private equity acquisitions, business combinations have been common in telecommunications, defense, banking and financial services, information technology, energy and natural resources, entertainment, pharmaceuticals, and manufacturing. Some of the world's largest companies and best-known names have been involved in recent major acquisitions, such as Procter & Gamble, Gillette, Citigroup, Bank of America, AT&T, Whirlpool, Sprint, Verizon, Adobe Systems, Chrysler, Daimler, ConocoPhillips, BP, and ExxonMobil.

FYI

Historically, mergers have come in waves as indicated by the following summary:

Period	Name	Facet
1897–1904	First Wave	Horizontal mergers
1916–1929	Second Wave	Vertical mergers
1965–1969	Third Wave	Diversified conglomerate mergers
1981–1989	Fourth Wave	Congeneric mergers; hostile takeovers; corporate raiding, LBOs
1992–2000	Fifth Wave	Cross-border mergers
2003–2008	Sixth Wave	Shareholder activism, private equity, LBOs
2010–2014	Seventh Wave	Global expansion

Sources: Martin Lipton, "Merger Waves in the 19th, 20th and 21st Centuries," *The Davies Lecture,* York University, September 14, 2006."
Michael J. De La Merced and Jeffrey Cane, "Confident Deal Makers Pulled Out Checkbooks in 2010," *The New York Times,* January 3, 2011.

Ethical Considerations

Acquisitions can sometimes lead to ethical challenges for managers. Corporate managers are often rewarded with higher salaries as their companies increase in size. In addition, prestige frequently increases with the size of a company and with a reputation for the successful acquisition of other companies. As a result, corporate managers often find it personally advantageous to increase company size. For instance, Bernard Ebbers started his telecommunications career as the head of a small discount long-distance telephone service company and built it into one of the world's largest corporations, WorldCom. In the process, Ebbers became well known for his acquisition prowess and grew tremendously wealthy—until WorldCom was racked by accounting scandals and declared bankruptcy and Ebbers was sentenced to prison in 2003.

Acquisitions and complex organizational structures have sometimes been used to manipulate financial reporting with the aim of enhancing or enriching managers. Many major corporations, taking advantage of loopholes or laxness in financial reporting requirements, have used subsidiaries or other entities to borrow large amounts of money without reporting the debt on their balance sheets. Some companies have created special entities that have then been used to manipulate profits.

The term *special-purpose entity* has become well known in recent years because of the egregious abuse of these entities by companies such as Enron. A ***special-purpose entity*** (SPE) is, in general, a financing vehicle that is not a substantive operating entity, usually one created for a single specified purpose. An SPE may be in the form of a corporation, trust, or partnership. Enron, one of the world's largest companies prior to its collapse in 2001, established many SPEs, at least some of which were intended to manipulate financial reporting. Some of Enron's SPEs apparently were created primarily to hide debt, and others were used to create fictional transactions or to convert borrowings into reported revenues. The FASB has since clarified the rules around the accounting for SPEs to avoid this issue.

Accounting for mergers and acquisitions is also an area that can lend itself to manipulation. Arthur Levitt, former chairman of the SEC, referred to some of the accounting

[3] Dennis K. Berman and Jason Singer, "Blizzard of Deals Heralds an Era of Megamergers," *The Wall Street Journal,* June 27, 2006, p. A1.

practices that have been used in accounting for mergers and acquisitions as "creative acquisition accounting" or "merger magic." For example, an approach used by many companies in accounting for their acquisitions was to assign a large portion of the purchase price of an acquired company to its in-process research and development, immediately expensing the full amount and freeing financial reporting in future periods from the burden of those costs. The FASB has since eliminated this practice.

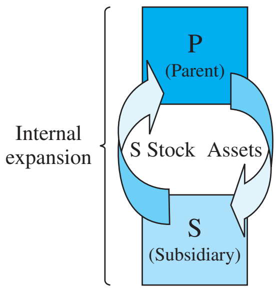
The scandals and massive accounting failures at companies such as Enron, WorldCom, and Tyco—causing creditors, investors, employees, and others to suffer heavy losses—focused considerable attention on weaknesses in accounting and the accounting profession. In the past several years, Congress, the SEC, and the FASB have taken actions to strengthen the financial reporting process and to clarify the accounting rules relating to special entities and to acquisitions. However, the frequency and size of business combinations, the complexity of accounting, and the potential impact on financial statements of the accounting methods employed mean that the issues surrounding the accounting for business combinations are still of critical importance.

BUSINESS EXPANSION AND FORMS OF ORGANIZATIONAL STRUCTURE

Historically, businesses have expanded by internal growth through new product development and expansion of existing product lines into new markets. In recent decades, however, many companies have chosen to expand by combining with or acquiring other companies. Either approach may lead to a change in organizational structure.

Internal Expansion: Creating a Business Entity

As companies expand from within, they often find it advantageous to conduct their expanded operations through new subsidiaries or other entities such as partnerships, joint ventures, or special entities. In most of these situations, an identifiable segment of the company's existing assets is transferred to the new entity (Subsidiary), and in exchange, the transferring company (Parent) receives equity ownership.



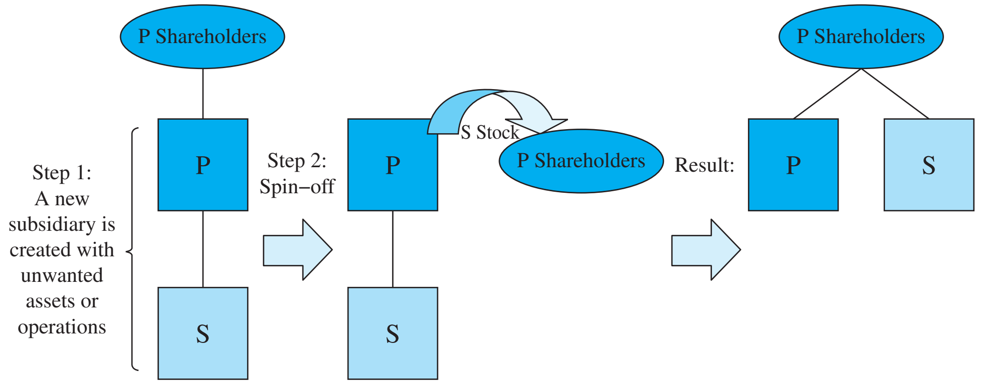
Companies may be motivated to establish new subsidiaries or other entities for a variety of reasons. Broadly diversified companies may place unrelated operations in separate subsidiaries to establish clear lines of control and facilitate the evaluation of operating results. In some cases, an entity that specializes in a particular type of activity or has its operations in a particular country may qualify for special tax incentives. Of particular importance in some industries is the fact that a separate legal entity may be permitted to operate in a regulatory environment without subjecting the entire entity to regulatory control. Also, by creating a separate legal entity, a parent company may be able to protect itself from exposing the entire company's assets to legal liability that may stem from a new product line or entry into a higher-risk form of business activity.

Companies also might establish new subsidiaries or other entities, not as a means of expansion, but as a means of disposing of a portion of their existing operations through outright sale or a transfer of ownership to existing shareholders or others. In some cases, companies have used this approach to dispose of a segment of operations that no longer fits well with the overall

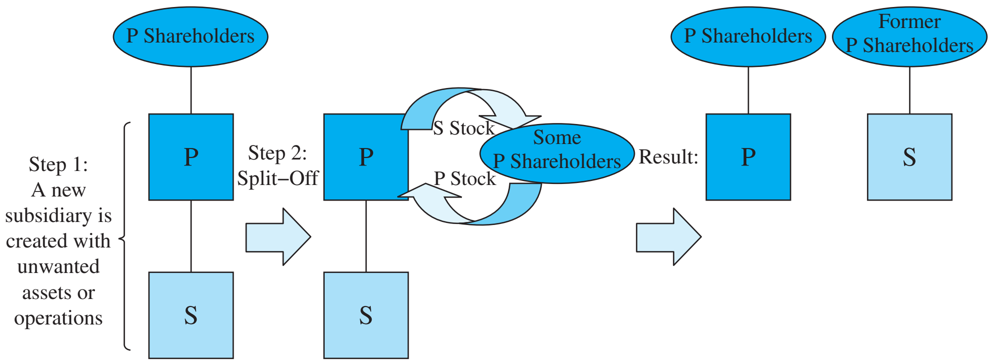
FYI

In October of 2012 Kraft spun off its $32 billion snack business in order to better focus on its grocery business and other strategic goals.

mission of the company. In other cases, this approach has been used as a means of disposing of unprofitable operations or to gain regulatory or shareholder approval of a proposed merger with another company. A ***spin-off*** occurs when the ownership of a newly created or existing subsidiary is distributed to the parent's stockholders without the stockholders surrendering any of their stock in the parent company. Thus, the company divests itself of the subsidiary because it is owned by the company's shareholders after the spin-off.

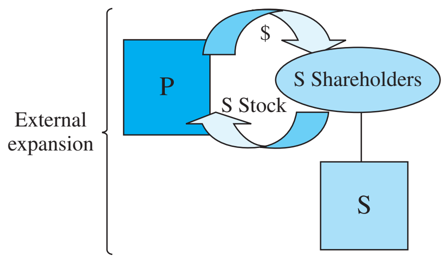


A ***split-off*** occurs when the subsidiary's shares are exchanged for shares of the parent, thereby leading to a reduction in the parent company's outstanding shares. Although the two divestiture types are similar, the split-off could result in one set of the former parent shareholders exchanging their shares for those of the divested subsidiary.



External Expansion: Business Combinations

Many times companies find that entry into new product areas or geographic regions is more easily accomplished by acquiring or combining with other companies than through internal expansion. For example, SBC Communications, a major telecommunications company and one of the "Baby Bells," significantly increased its service area by combining with Pacific Telesis and Ameritech, later acquiring AT&T (and adopting its name), and subsequently combining with BellSouth. Similarly, because the state of Florida has traditionally been very reluctant to issue new bank charters, bank corporations wishing to establish operations in Florida have had to acquire an existing bank to obtain a charter in the state.



A business can be defined as an organization or enterprise engaged in providing goods or services to customers. However, a business doesn't necessarily have to be a separate legal entity. A ***business combination*** occurs when ". . . an acquirer obtains control of one or more businesses."[4] The diagram on the preceding page illustrates a typical acquisition. The concept of ***control*** relates to the ability to direct policies and management. Traditionally, control over a company has been gained by acquiring a majority of the company's common stock. However, the diversity of financial and operating arrangements employed in recent years also raises the possibility of gaining control with less than majority ownership or, in some cases, with no ownership at all through other contractual arrangements.

FYI

On April 2, 2012, Zynga Inc. purchased its previously leased corporate headquarters building located in San Francisco, California, to support the overall growth of its business. In accordance with **ASC 805,** "Business Combinations," Zynga accounted for the building purchase as a business combination even though it wasn't a stand-alone legal entity because (it argued) the building met the definition of a business.

The types of business combinations found in today's business environment and the terms of the combination agreements are as diverse as the firms involved. Companies enter into various types of formal and informal arrangements that may have at least some of the characteristics of a business combination. Most companies tend to avoid recording informal agreements on their books because of the potential difficulty of enforcing them. In fact, some types of informal arrangements, such as those aimed at fixing prices or apportioning potential customers, are illegal. Formal agreements generally are enforceable and are more likely to be recognized on the books of the participants.

Organizational Structure and Financial Reporting

When companies expand or change organizational structure by acquiring other companies or through internal division, the new structure must be examined to determine the appropriate financial reporting procedures. Several approaches are possible, depending on the circumstances:

1. **Merger** A merger is a business combination in which the acquired business's assets and liabilities are combined with those of the acquiring company. Thus, two companies are merged into a single entity. In essence, the acquiring company "swallows" the acquired business.
2. **Controlling ownership** A business combination in which the acquired company remains as a separate legal entity with a majority of its common stock owned by the purchasing company leads to a parent–subsidiary relationship. Accounting standards normally require that the financial statements of the parent and subsidiary be consolidated for general-purpose reporting so the companies appear as a single entity. The treatment is the same if the subsidiary is created rather than purchased. The treatment is also the same when the other entity is unincorporated and the investor company has control and majority ownership.[5]
3. **Noncontrolling ownership** The purchase of a less-than-majority interest in another corporation does not usually result in a business combination or controlling situation. A similar situation arises when a company creates another entity and holds less than a controlling position in it or purchases a less-than-controlling interest in an existing partnership. In its financial statements, the investor company reports its interest in the investee as an investment with the specific method of accounting (cost method, equity method, consolidation) dictated by the circumstances.
4. **Other beneficial interest** One company may have a beneficial interest in another entity even without a direct ownership interest. The beneficial interest may be defined by the agreement establishing the entity or by an operating or financing agreement. When the beneficial interest is based on contractual arrangements instead of majority stock

[4] **ASC 805-10-65-1.**

[5] Majority ownership is generally a sufficient but not a necessary condition for the indicated treatment. Unlike the corporate case, percentage ownership does not fully describe the nature of a beneficial interest in a partnership. Investments in partnerships are discussed in later chapters.

ownership, the reporting rules may be complex and depend on the circumstances. In general, a company that has the ability to make decisions significantly affecting the results of another entity's activities or is expected to receive a majority of the other entity's profits and losses is considered to be that entity's ***primary beneficiary.*** Normally, that entity's financial statements would be consolidated with those of the primary beneficiary.

These different situations, and the related accounting and reporting procedures, are discussed throughout the first 10 chapters of the text. The primary focus is on the first three situations, especially the purchase of all or part of another company's stock. The discussion of the fourth situation in Chapter 3 is limited because of its complexity and the diversity of these contractual arrangements.

THE DEVELOPMENT OF ACCOUNTING FOR BUSINESS COMBINATIONS

LO 1-2

Understand the development of standards related to acquisition accounting over time.

For more than half a century, accounting for business combinations remained largely unchanged. Two methods of accounting for business combinations, *the purchase method* and the ***pooling-of-interests method,*** were acceptable during that time. However, major changes in accounting for business combinations have occurred over the past 15 years. First, the FASB eliminated the pooling-of-interests method in 2001, leaving only a single method, purchase accounting. Then, in 2007, the FASB issued the revised standard (**ASC 805**) that replaced the purchase method with the *acquisition method,* which is now the only acceptable method of accounting for business combinations.

Although all business combinations must now be accounted for using the acquisition method, many companies' financial statements will continue to include the effects of previous business combinations recorded using the pooling-of-interests and purchase methods. Thus, a general understanding of these methods can be helpful.

The idea behind a pooling of interests was that no change in ownership had actually occurred in the business combination, often a questionable premise. Based on this idea, the book values of the combining companies were carried forward to the combined company and no revaluations to fair value were made. Managers often preferred pooling accounting because it did not result in asset write-ups or goodwill that might burden future earnings with additional depreciation or write-offs. Also, reporting practices often made acquisitions appear better than they would have appeared if purchase accounting had been used.

Purchase accounting treated the purchase of a business much like the purchase of any asset. The acquired company was recorded based on the purchase price that the acquirer paid. Individual assets and liabilities of the acquired company were valued at their fair values, and the difference between the total purchase price and the fair value of the net identifiable assets acquired was recorded as goodwill. All direct costs of bringing about and consummating the combination were included in the total purchase price.

Acquisition accounting is consistent with the FASB's intention to move accounting in general more toward recognizing fair values. Under acquisition accounting, the acquirer in a business combination, in effect, values the acquired company based on the fair value of the consideration given in the combination and the fair value of any noncontrolling interest not acquired by the acquirer.

ACCOUNTING FOR INTERNAL EXPANSION: CREATING BUSINESS ENTITIES[6]

LO 1-3

Make calculations and prepare journal entries for the creation of a business entity.

Companies that choose to conduct a portion of their operations through separate business entities usually do so through corporate subsidiaries, corporate joint ventures, or partnerships. The ongoing accounting and reporting for investments in corporate joint ventures and subsidiaries are discussed in Chapters 2 through 10. This section discusses the origination of these entities when the parent or investor creates them rather than purchases an interest in an existing corporation or partnership.

[6] To view a video explanation of this topic, visit advancedstudyguide.com.

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When a company transfers assets or operations to another entity that it has created, a vast number of variations in the types of entities and the types of agreements between the creating company and the created entity are possible. Accordingly, it is impossible to establish a single set of rules and procedures that will suffice in all situations. We focus on the most straightforward and common cases in which the transferring company creates a subsidiary or partnership that it owns and controls, including cases in which the company intends to transfer ownership to its stockholders through a spin-off or split-off. In simple cases, the company transfers assets, and perhaps liabilities, to an entity that the company has created and controls and in which it holds majority ownership. The company transfers assets and liabilities to the created entity at book value, and the transferring company recognizes an ownership interest in the newly created entity equal to the book value of the net assets transferred. Recognition of fair values of the assets transferred in excess of their carrying values on the books of the transferring company normally is not appropriate in the absence of an arm's-length transaction. Thus, no gains or losses are recognized on the transfer by the transferring company. However, if the value of an asset transferred to a newly created entity has been impaired prior to the transfer and its fair value is less than the carrying value on the transferring company's books, the transferring company should recognize an impairment loss and transfer the asset to the new entity at the lower fair value.

FYI

An "arm's-length transaction" is one in which the parties are completely independent of one another so that they act in their personal best interests or to maximize their own wealth. Thus, there is no chance of collusion between them.

The created entity begins accounting for the transferred assets and liabilities in the normal manner based on their book values at the time of transfer. Subsequent financial reporting involves consolidating the created entity's financial statements with those of the parent company. Overall, the consolidated financial statements appear the same as if the transfer had not taken place.

As an illustration of a created entity, assume that Allen Company creates a subsidiary, Blaine Company, and transfers the following assets to Blaine in exchange for all 100,000 shares of Blaine's $2 par common stock:

Item	Cost	Book Value
Cash		$ 70,000
Inventory	$ 50,000	50,000
Land	75,000	75,000
Building	100,000	80,000
Equipment	250,000	160,000
		$435,000

Allen records the transfer with the following entry:[7]

(1)	Investment in Blaine Company Common Stock	435,000	
	Accumulated Depreciation, Building	20,000	
	Accumulated Depreciation, Equipment	90,000	
	Cash		70,000
	Inventory		50,000
	Land		75,000
	Building		100,000
	Equipment		250,000

Record the creation of Blaine Company.

[7] Journal entries used in the text to illustrate the various accounting procedures are numbered sequentially within individual chapters for easy reference. Each journal entry number appears only once in a chapter.