Advanced Financial Accounting

Tenth Edition

Christensen | Cottrell | Baker

connect plus+ ACCOUNTING

The integrated solutions for Christensen's *Advanced Financial Accounting*, *10e*, have been proven to help you achieve your course goals of improving student readiness, enhancing student engagement, and increasing their comprehension of content. Known for its engaging style, the Christensen solution employs the use of current companies and instant feedback on practice problems to help students engage with course materials, comprehend the content, and achieve higher outcomes in the course.

Christensen's *Advanced Financial Accounting*, *10e*, now includes **algorithmic problems** in *Connect*! Algorithmically generated numbers for selected problems are available with each chapter within *Connect*.

In addition, our new **Intelligent Response Technology**-based content offers students an intelligent homework experience that helps them stay focused on learning instead of navigating the technology.

PROVEN EFFECTIVE

Get Connected.

FEATURES

Connect Accounting's algorithmic problems provide students with an individualized problem and customized explanations of each calculation. Algorithmic problems allow instructors flexibility in creating homework assignments as the numbers automatically generate, causing a variety of different sets to choose from.

Intelligent Response Technology

Intelligent Response Technology (IRT) is *Connect Accounting's* new student interface for end-of-chapter assessment content. Intelligent Response Technology provides a general journal application that looks and feels more like what you would find in a general ledger software package, improves answer acceptance to reduce student frustration with formatting issues (such as rounding), and, for select questions, provides an expanded table that guides students through the process of solving the problem.

Get Engaged.

eBooks

Connect Plus includes a media-rich eBook that allows you to share your notes with your students. Your students can insert and review their own notes, highlight the text, search for specific information, and interact with media resources. Using an eBook with *Connect Plus* gives your students a complete digital solution that allows them to access their materials from any computer.

Lecture Capture

Make your classes available anytime, anywhere. With simple, one-click recording, students can search for a word or phrase and be taken to the exact place in your lecture that they need to review.

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Tenth Edition

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McGraw-Hill Irwin

ADVANCED FINANCIAL ACCOUNTING, TENTH EDITION

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Some ancillaries, including electronic and print components, may not be available to customers outside the United States.

This book is printed on acid-free paper.

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

ISBN 978-0-07-802562-4
MHID 0-07-802562-1

Senior Vice President, Products & Markets: *Kurt L. Strand*
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Lead Designer: *Matthew Baldwin*
Cover/Interior Designer: *Matthew Baldwin*
Cover Image: *Enzo Figueres/Getty Images*
Lead Media Project Manager: *Brian Nacik*
Media Project Manager: *Alpana Jolly*
Typeface: *10.5/12 Times Roman Lt. Std.*
Compositor: *Laserwords Private Limited*
Printer: *Quad/Graphics*

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Library of Congress Cataloging-in-Publication Data

Christensen, Theodore E.
Advanced financial accounting / Theodore E. Christensen, Brigham Young University, David M. Cottrell, Brigham Young University, Richard E. Baker, Northern Illinois University; with contributions from: Valdean C. Lembke, Professor Emeritus, University of Iowa, Thomas E. King, Professor Emeritus, Southern Illinois University, Edwardsville, Cynthia G. Jeffrey, Iowa State University.—Tenth edition.
pages cm
Includes index.
ISBN 978-0-07-802562-4 (alk. paper)—ISBN 0-07-802562-1 (alk. paper)
1. Accounting. I. Cottrell, David M. II. Baker, Richard E. III. Title.
HF5636.B348 2014
657'.046—dc23

2012050314

The Internet addresses listed in the text were accurate at the time of publication. The inclusion of a website does not indicate an endorsement by the authors or McGraw-Hill, and McGraw-Hill does not guarantee the accuracy of the information presented at these sites.

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About the Authors

Theodore E. Christensen

Ted Christensen has been a faculty member at Brigham Young University since 2000. Prior to coming to BYU, he was on the faculty at Case Western Reserve University for five years. He received a BS degree in accounting at San Jose State University, a MAcc degree in tax at Brigham Young University, and a PhD in accounting from the University of Georgia. Professor Christensen has authored and coauthored articles published in many journals including *The Accounting Review,* the *Journal of Accounting Research,* the *Journal of Accounting and Economics, Review of Accounting Studies, Contemporary Accounting Research, Accounting Organizations and Society,* the *Journal of Business Finance & Accounting, Accounting Horizons,* and *Issues in Accounting Education.* Professor Christensen has taught financial accounting at all levels, financial statement analysis, both introductory and intermediate managerial accounting, and corporate taxation. He is the recipient of numerous awards for both teaching and research. He has been active in serving on various committees of the American Accounting Association and is a CPA.

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, The Journal of Accounting Case Research, The Quarterly Review of Distance Education, Journal of Accountancy, The CPA Journal, Internal Auditor, The Tax Executive,* and *The Journal of International Taxation,* among others.

Richard E. Baker

Richard E. Baker was a member of the faculty of Northern Illinois University for 26 years. His academic recognitions include having been named the Ernst & Young Distinguished Professor of Accountancy at Northern Illinois University. In addition, he has been recognized as an inaugural University Presidential Teaching Professor, the highest teaching recognition of his university. He received his BS degree from the University of Wisconsin at River Falls and his MBA and PhD from the University of Wisconsin at Madison. His activities in the American Accounting Association have been continuous over many years and include service on the AAA's Executive Committee as the Director of Education of the AAA; as a member of the AAA's Council; as the Chair of the Teaching and Curriculum Section; and as the President of the Midwest Region. His lengthy service to the Federation of Schools of Accountancy (FSA) includes the offices of the President, the Vice President, and the Secretary. Many of his extensive professional and academic organization committee service efforts have involved research in assessing teaching and learning outcomes, designing innovative curriculum models, developing meaningful measurement criteria for evaluating accounting programs, and continually

integrating new electronic technology into the accounting classroom. Professor Baker has received numerous teaching awards at both the undergraduate and graduate levels and has been selected as the Illinois CPA Society's Outstanding Accounting Educator. His most recent published research studies have concentrated on ways to make the learning/teaching experience as effective as possible.

Preface

The Tenth 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, bankruptcies of major firms, and other topics typically included in advanced accounting. Accountants must understand and know how to deal with the accounting and reporting ramifications of these issues.

OVERVIEW

The Tenth Edition of *Advanced Financial Accounting* continues to provide strong coverage of advanced accounting topics with clarity of presentation and integrated coverage based on continuous case examples. The text is highly illustrated with complete presentations of worksheets, schedules, and financial statements so that 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 has become especially important given the recent rapid pace of the authoritative bodies in dealing with major issues having far-reaching implications. An overview of the contents and organization for the Tenth Edition is illustrated below.

Multi-Corporate 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 Noncurrent Assets and Services
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 Government-wide Financial Statements

Not-for-Profit

19 Not-for-Profit Entities

Corporations in Financial Difficulty

20 Corporations in Financial Difficulty

NEW FEATURES ADDED IN THE TENTH EDITION

- **Callout boxes.** We have added three types of "callout boxes" that appear in the left-hand margin to draw attention to important points throughout the chapters. The most common callout boxes in the tenth edition 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. We believe these callout boxes will help students to better understand difficult concepts and make the textbook more interesting to read.
- **New shading of consolidation worksheet entries.** Feedback from textbook adopters prompted us to revise 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 and students, we have extensively rewritten Chapters 6, 7, and 8 to better illustrate and explain some of the most difficult concepts covered in the consolidation area.
- **New FASB codification.** All authoritative citations to U.S. GAAP are now exclusively cited based on the new FASB codification.

KEY FEATURES MAINTAINED IN THE TENTH 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 Tenth Edition include:

- **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 xvi.

- **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 Tenth 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 continuing 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 Tenth 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 xiv 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:

  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.

MCGRAW-HILL'S *CONNECT® ACCOUNTING*

Less Managing. More Teaching. Greater Learning.

McGraw-Hill's *Connect® Accounting* is an online assignment and assessment solution that connects students with the tools and resources they'll need to achieve success.

McGraw-Hill's *Connect® Accounting* helps prepare students for their future by enabling faster learning, more efficient studying, and higher retention of knowledge.

McGraw-Hill's *Connect® Accounting* Features

McGraw-Hill's *Connect® Accounting* offers a number of powerful tools and features to make managing assignments easier so faculty can spend more time teaching. With McGraw-Hill's *Connect® Accounting,* students can engage with their coursework anytime and anywhere, making the learning process more accessible and efficient. McGraw-Hill's *Connect® Accounting* offers you the features described below.

Simple Assignment Management

With McGraw-Hill's *Connect® Accounting,* creating assignments is easier than ever, so you can spend more time teaching and less time managing. The assignment management function enables you to

- Create and deliver assignments easily with selectable end-of-chapter questions and test bank items.
- Streamline lesson planning, student progress reporting, and assignment grading to make classroom management more efficient than ever.
- Go paperless with the eBook and online submission and grading of student assignments.

Smart Grading

When it comes to studying, time is precious. McGraw-Hill's *Connect® Accounting* helps students learn more efficiently by providing feedback and practice material when they need it, where they need it. When it comes to teaching, your time also is precious. The grading function enables you to

- 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 tests and instant quizzes.

Instructor Library

The McGraw-Hill's *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 McGraw-Hill's *Connect® Accounting* Instructor Library includes

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

Student Study Center

The McGraw-Hill's *Connect® Accounting* Student Study Library is the place for students to access additional resources. The Student Library

- Offers students quick access to lectures, practice materials, eBooks, and more.
- Provides instant practice material and study questions, easily accessible on the go.

Student Progress Tracking

McGraw-Hill's *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.

McGraw-Hill's *Connect® Plus Accounting*

McGraw-Hill reinvents the textbook learning experience for the modern student with McGraw-Hill's *Connect® Plus Accounting.* A seamless integration of an eBook and McGraw-Hill's *Connect® Accounting,* McGraw-Hill's *Connect® Plus Accounting* provides all of McGraw-Hill's *Connect® Accounting* features plus the following:

- An integrated eBook, allowing for anytime, anywhere access to the textbook.
- Dynamic links between the problems or questions you assign to your students and the location in the eBook where that problem or question is covered.
- A powerful search function to pinpoint and connect key concepts in a snap.

In short, McGraw-Hill's *Connect® Accounting* offers you and your students powerful tools and features that optimize your time and energies, enabling you to focus on course content, teaching, and student learning. McGraw-Hill's *Connect® Accounting* also offers a wealth of content resources for both instructors and students. This state-of-the-art, thoroughly tested system supports you in preparing students for the world that awaits.

For more information about McGraw-Hill's *Connect*® *Accounting,* go to **www.mcgrawhillconnect.com,** or contact your local McGraw-Hill sales representative.

TEGRITY CAMPUS: LECTURES 24/7

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 or Mac, an iPod, or other mobile device.

Educators know that the more students can see, hear, and experience class resources, the better they learn. In fact, studies prove it. Tegrity Campus's unique search feature helps students efficiently find what they need, when they need it, across an entire semester of class recordings. Help turn your students' study time into learning moments immediately supported by your lecture. With Tegrity Campus, you also increase intent listening and class participation by easing students' concerns about note taking. Lecture Capture will make it more likely you will see students' faces, not the tops of their heads.

To learn more about Tegrity, watch a two-minute Flash demo at **http://tegritycampus.mhhe.com**.

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MCGRAW-HILL HIGHER EDUCATION AND BLACKBOARD HAVE TEAMED UP. WHAT DOES THIS MEAN FOR YOU?

1. **Your life, simplified.** Now you and your students can access McGraw-Hill's *Connect*® and Create™ right from within your Blackboard course—all with one single sign-on. Say good-bye to the days of logging in to multiple applications.
2. **Deep integration of content and tools.** Not only do you get single sign-on with *Connect*® and Create™ but also you get deep integration of McGraw-Hill content and content engines right in Blackboard. Whether you're choosing a book for your course or building *Connect*® assignments, all the tools you need are right where you want them—inside of Blackboard.
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4. **A solution for everyone.** Whether your institution is already using Blackboard or you just want to try Blackboard on your own, we have a solution for you. McGraw-Hill and Blackboard can now offer you easy access to industry-leading technology and content whether your campus hosts it or we do. Be sure to ask your local McGraw-Hill representative for details.

In addition to Blackboard integration, course cartridges for whatever online course management system you use (e.g., WebCT or eCollege) are available for *Advanced Financial Accounting*, Tenth Edition. Our cartridges are specifically designed to make it easy to navigate and access content online. They are easier than ever to install on the latest version of the course management system available today.

SUPPLEMENTS FOR INSTRUCTORS

- *Online Learning Center (OLC).* We offer an Online Learning Center (OLC) that follows *Advanced Financial Accounting* chapter by chapter. It doesn't require any building or maintenance on your part. It's ready to go the moment you and your students type in the URL: **www.mhhe.com/christensen10e**.

  The OLC includes

  - PowerPoint® presentations
  - Excel worksheets
  - Check figures
  - Test Bank

- *New instructor resources.* The authors have developed a new set of PowerPoint slides designed to accompany the Tenth Edition. These slides do much more than summarize the topics in each chapter. They illustrate key concepts and include group exercises and practice quiz questions to give students hands-on practice in class to better prepare them for future homework and assessment experiences. Instructors benefit from proven interactive class discussions and exercises fully annotated by the authors.
- *Solutions Manual.* The solutions manual, created by the authors, provides solutions for all questions, cases, exercises, and problems in the text. The solutions are carefully explained and logically presented. Answers for the multiple-choice questions include computations and explanations.
- *Test Bank.* Revised by the authors, this comprehensive collection of both conceptual and procedural test items has been updated for the new edition. Also new with this edition is a wide variety of Kaplan CPA questions. The material is organized by chapter and includes a large variety of multiple-choice questions, exercises, and problems that can be used to measure student achievement in the topics in each chapter. The test items are closely coordinated with the text to ensure consistency.
- *Instructors' Resource Manual.* The Instructor's Resource Manual includes chapter outlines, additional examples, teaching suggestions on how to use the PowerPoint slides, and other materials to assist instructors in making the most effective use of the text.
- *Instructor Updates.* This feature contains timely discussions and illustrations of major accounting or financial reporting issues under deliberation by standard-setting bodies. Instructors can choose to share them with their students.

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 in 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.

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* Tenth 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* Tenth 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* Tenth Edition and the teaching package make no claim of any specific AACSB qualification or evaluation, we have within *Advanced Financial Accounting* Tenth Edition labeled selected questions according to the six general knowledge and skills areas.

SUPPLEMENTS FOR STUDENTS

- McGraw-Hill's *Connect® Plus Accounting*

  This integrates all of the text's multimedia resources. Students can obtain state-of-the-art study aids, including an online version of the text.

- McGraw-Hill's *Connect® Accounting*

  This Web-based software duplicates problem structures directly from the end-of-chapter material in the textbook. It shows students where they made errors. All applicable exercises and problems are available with McGraw-Hill's *Connect® Accounting*.

Available on the Online Learning Center at www.mhhe.com/christensen10e

- *Excel Worksheets.* The worksheets for use with Excel are provided to facilitate completion of problems requiring numerous mechanical computations.
- *Check Figures.* Prepared by the text authors, a list of answers is provided separately for many of the end-of-chapter materials in the text.
- *Microsoft PowerPoint Slides®*. These are available by chapter to facilitate note taking and review.

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

Advanced StudyGuide .com

The Tenth 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

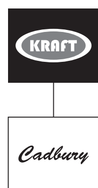
- The answer, at least in part, is the ASG: the authors' attempt to partner with you in helping to better serve students' needs in some of the common situations where questions arise, without using more of your scarce time.
- The ASG will allow you to refer to streaming media discussions where the authors 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 completely revised and reorganized 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 callout boxes to provide real-world examples of the topics discussed in the chapter, some of which provide additional information about the **Kraft Foods, Inc.,** acquisition of **Cadbury PLC** from the introductory vignette.

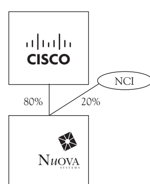
BERKSHIRE HATHAWAY INC.

- **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). This chapter introduces a new method of shading our consolidation worksheet entries to make them easily distinguishable by the reader. We have rewritten this chapter to provide a more streamlined coverage of topics traditionally included in this chapter. Finally, we have added new "callout boxes" to 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.

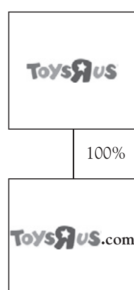
- **Chapter 3** explores how the basic consolidation process differs when a subsidiary is only partially owned. Moreover, it introduces the notion of special-purpose entities and accounting standards related to variable interest entities by discussing the well-known collapse of **Enron Corporation.** We have reorganized this chapter based on feedback from adopters to provide a better flow for the material. In addition, we have added new 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

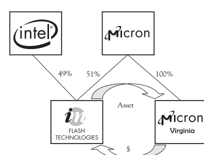
worksheet entries introduced in Chapter 2. Finally, we have included one new call-out box illustrating a real-world example of one of the important topics discussed in the chapter.



- **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 streamlined this chapter by moving some of the tangential material to the appendix. Moreover, we have added a new callout box illustrating one of the more complex issues discussed in the chapter.



- **Chapter 6** introduces intercompany inventory transfers based on **Toys "R" Us** and its 100 percent owned subsidiary **Toysrus.com.** 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 an entire section explaining how to calculate unrealized intercompany profits. Our new approach substantially simplifies the process for students. We introduce many new graphics to carefully illustrate this new approach. 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 many new graphics and illustrations to ensure that this material is more accessible and easy to understand. In addition, we have added one new callout box to better explain the deferral of intercompany profits on the parent company's books.

- **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 is 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 is not representative of real-world accounting treatment. As a result, we have rewritten the chapter to illustrate the use of the effective interest method. However, because some adopters have long used the straight-line method, we have 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. We provide a complete set of supplements (Solutions Manual, PowerPoint slides, Test Bank) for both methods.

- **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. To streamline the chapter, we have removed the material on partnerships because partnerships are covered in Chapters 15 and 16. Moreover, we have added several new real-world examples in callout boxes to illustrate key topics in the chapter.

- **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 added several new callout boxes to illustrate key topics with real companies and to clarify difficult concepts.

- **Chapter 11** focuses on foreign currency transactions, financial instruments, and the effects that changes in exchange rates can have on reported results. We have added several new callout boxes to provide real-world examples of the topics discussed in the chapter, some of which provide additional information regarding the introductory vignette about **Microsoft.**

- **Chapter 12** resumes the discussion of international accounting by looking at **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. As a result, we have added new illustrations and one new callout box to help students better understand the technical topics discussed in this chapter.

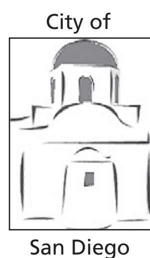
- **Chapter 13** examines segment reporting. We have made minor revisions to more clearly discuss the accounting standards for reporting an entity's operating components, foreign operations, and major customers and have added several callout boxes illustrating how real companies, including **Walmart** 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 streamline this chapter and have added two new callout boxes to clarify and better illustrate regulatory reporting.

- **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 (especially changes in ownership) and have added several callout boxes to better explain topics covered in the chapter.

- **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 and added a series of callout boxes to clarify some of the more difficult concepts

related to partnership liquidation. Note that we have made a slight change to the presentation of the statement of realization and liquidation. Instead of presenting the accounts as debits and credits (which sometimes become confusing for students), we simply use the accounting equation to present asset, liability, and capital account balances as positive numbers (except for deficit capital balances, which are presented as negative numbers). Additions to or subtractions from account balances (no longer shown as debits and credits) always sum to zero.



- **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 (including a new graphic to illustrate how encumbrances affect the remaining appropriating authority of a governmental unit). Moreover, we have added a series of 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 government-wide financial statements. We have lightly revised the chapter topics that are often misunderstood by students and have added some callout boxes (which highlight specific examples related to the introductory vignette about the state of **Maryland**).

- **Chapter 19** introduces accounting for not-for-profit entities using the example of **United Way,** 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 added 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 added 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 Morgan Fillmore, Kaid Gordon, Jacob Hager, Aaron Hamilton, Ben Jumper, Jeff Pooley, Cassy Budd, and Melissa Larson, all from Brigham Young University.

We express our sincere thanks to the following individuals who provided reviews on the Ninth Edition:

Jason Bergner
University of Central Missouri

Fatma Cebenoyan
Hunter College

Carlos Diaz
Johnson & Wales University

David Doyon
Southern New Hampshire University

Mark Holtzman
Seton Hall University

Charles Lewis
University of Houston–Downtown

Barbara Reeves
Cleary University

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/Irwin team: Tim Vertovec, James Heine, Danielle Andries, Diane Nowaczyk, Dean Karampelas, Matt Baldwin, 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
Richard E. Baker

Brief Table of Contents

PREFACE vii

1 Intercorporate Acquisitions and Investments in Other Entities 1

2 Reporting Intercorporate Investments and Consolidation of Wholly Owned Subsidiaries with No Differential 47

3 The Reporting Entity and the Consolidation of Less-than-Wholly-Owned Subsidiaries with No Differential 100

4 Consolidation of Wholly Owned Subsidiaries Acquired at More than Book Value 149

5 Consolidation of Less-than-Wholly-Owned Subsidiaries Acquired at More than Book Value 202

6 Intercompany Inventory Transactions 249

7 Intercompany Transfers of Noncurrent Assets and Services 307

8 Intercompany Indebtedness 374

9 Consolidation Ownership Issues 451

10 Additional Consolidation Reporting Issues 503

11 Multinational Accounting: Foreign Currency Transactions and Financial Instruments 542

12 Multinational Accounting: Issues in Financial Reporting and Translation of Foreign Entity Statements 612

13 Segment and Interim Reporting 674

14 SEC Reporting 722

15 Partnerships: Formation, Operation, and Changes in Membership 749

16 Partnerships: Liquidation 804

17 Governmental Entities: Introduction and General Fund Accounting 842

18 Governmental Entities: Special Funds and Government-wide Financial Statements 901

19 Not-for-Profit Entities 968

20 Corporations in Financial Difficulty 1039

INDEX 1073

Table of Contents

ABOUT THE AUTHORS v

PREFACE vii

Chapter 1
Intercorporate Acquisitions and Investments in Other Entities 1

Kraft's Acquisition of Cadbury 1
An Introduction to Complex Business Structures 2
Enterprise Expansion 3
Business Objectives 3
Frequency of Business Combinations 3
Ethical Considerations 4
Business Expansion and Forms of Organizational Structure 5
Internal Expansion: Creating a Business Entity 5
External Expansion: Business Combinations 6
Organizational Structure and Financial Reporting 7
The Development of Accounting for Business Combinations 8
Accounting for Internal Expansion: Creating Business Entities 8
Accounting for External Expansion: Business Combinations 10
Forms of Business Combinations 10
Methods of Effecting Business Combinations 10
Valuation of Business Entities 12
Acquisition Accounting 13
Fair Value Measurements 14
Applying the Acquisition Method 14
Goodwill 14
Combination Effected through the Acquisition of Net Assets 15
Combination Effected through Acquisition of Stock 20
Financial Reporting Subsequent to a Business Combination 20
Additional Considerations in Accounting for Business Combinations 21
Uncertainty in Business Combinations 21
In-Process Research and Development 22
Noncontrolling Equity Held Prior to Combination 23
Summary of Key Concepts 23
Key Terms 24
Questions 24
Cases 24
Exercises 27
Problems 37

Chapter 2
Reporting Intercorporate Investments and Consolidation of Wholly Owned Subsidiaries with No Differential 47

Berkshire Hathaway's Many Investments 47
Accounting for Investments in Common Stock 48
The Cost Method 50
Accounting Procedures under the Cost Method 51
Declaration of Dividends in Excess of Earnings since Acquisition 51
Acquisition at Interim Date 52
Changes in the Number of Shares Held 53
The Equity Method 53
Use of the Equity Method 53
Investor's Equity in the Investee 54
Recognition of Income 54
Recognition of Dividends 55
Comparison of the Carrying Amount of the Investment and Investment Income under the Cost and Equity Methods 55
Acquisition at Interim Date 56
Changes in the Number of Shares Held 56
Comparison of the Cost and Equity Methods 58
The Fair Value Option 59
Overview of the Consolidation Process 60
Consolidation Procedures for Wholly Owned Subsidiaries That Are Created or Purchased at Book Value 60
Consolidation Worksheets 61
Worksheet Format 61
Nature of Elimination Entries 62
Consolidated Balance Sheet with Wholly Owned Subsidiary 63
100 Percent Ownership Acquired at Book Value 63
Consolidation Subsequent to Acquisition 68
Consolidated Net Income 68
Consolidated Retained Earnings 69
Consolidated Financial Statements—100 Percent Ownership, Created or Acquired at Book Value 70
Initial Year of Ownership 71
Second and Subsequent Years of Ownership 74
Consolidated Net Income and Retained Earnings 76
Summary of Key Concepts 77
Key Terms 78
APPENDIX 2A
Additional Considerations Relating to the Equity Method 78

APPENDIX 2B
Consolidation and the Cost Method 81
Questions 83
Cases 85
Exercises 87
Problems 93
Kaplan CPA Review 99

Chapter 3
The Reporting Entity and the Consolidation of Less-than-Wholly-Owned Subsidiaries with No Differential 100

The Collapse of Enron and the Birth of a New Paradigm 100
The Usefulness of Consolidated Financial Statements 102
Limitations of Consolidated Financial Statements 102
Subsidiary Financial Statements 103
Consolidated Financial Statements: Concepts and Standards 103
Traditional View of Control 103
Indirect Control 104
Ability to Exercise Control 104
Differences in Fiscal Periods 105
Changing Concept of the Reporting Entity 105
Noncontrolling Interest 106
Computation and Presentation of Noncontrolling Interest 106
The Effect of a Noncontrolling Interest 107
Consolidated Net Income 108
Consolidated Retained Earnings 109
Worksheet Format 110
Consolidated Balance Sheet with a Less-Than-Wholly-Owned Subsidiary 110
80 Percent Ownership Acquired at Book Value 110
Consolidation Subsequent to Acquisition—80 Percent Ownership Acquired at Book Value 113
Initial Year of Ownership 114
Second and Subsequent Years of Ownership 116
Combined Financial Statements 119
Special-Purpose and Variable Interest Entities 120
Off-Balance Sheet Financing 120
Variable Interest Entities 121
IFRS Differences in Determining Control of VIEs and SPEs 123
Summary of Key Concepts 124
Key Terms 125
APPENDIX 3A
Consolidation of Variable Interest Entities 125
APPENDIX 3B
Additional Considerations 126
Questions 129
Cases 130
Exercises 132
Problems 140

Chapter 4
Consolidation of Wholly Owned Subsidiaries Acquired at More than Book Value 149

How Much Work Does It Really Take to Consolidate? Ask the People Who Do It at Disney 149
Dealing with the Differential 150
The Difference between Acquisition Price and Underlying Book Value 151
Additional Considerations 154
Pixar Acquisition Details from the 2006 Disney 10-K 154
Consolidation Procedures for Wholly Owned Subsidiaries Acquired at More than Book Value 156
Treatment of a Positive Differential 159
Illustration of Treatment of a Complex Differential 160
100 Percent Ownership Acquired at Less than Fair Value of Net Assets 164
Illustration of Treatment of Bargain-Purchase Differential 164
Consolidated Financial Statements—100 Percent Ownership Acquired at More than Book Value 166
Initial Year of Ownership 166
Second Year of Ownership 171
Intercompany Receivables and Payables 175
Push-Down Accounting 175
Summary of Key Concepts 176
Key Terms 176
APPENDIX 4A
Push-Down Accounting Illustrated 176
Questions 179
Cases 179
Exercises 181
Problems 192

Chapter 5
Consolidation of Less-than-Wholly-Owned Subsidiaries Acquired at More than Book Value 202

Cisco Acquires a Controlling Interest in Nuova 202
A Noncontrolling Interest in Conjunction with a Differential 203
Consolidated Balance Sheet with Majority-Owned Subsidiary 203
Consolidated Financial Statements with a Majority-Owned Subsidiary 206
Initial Year of Ownership 206
Second Year of Ownership 210
Discontinuance of Consolidation 213
Treatment of Other Comprehensive Income 216
Modification of the Consolidation Worksheet 216

Adjusting Entry Recorded by Subsidiary 216
Adjusting Entry Recorded by Parent Company 217
Consolidation Worksheet—Second Year Following Combination 217
Consolidation Procedures 217
Consolidation Worksheet—Comprehensive Income in Subsequent Years 220
Summary of Key Concepts 220
Key Terms 221
APPENDIX 5A
Additional Consolidations Details 221
Questions 223
Cases 223
Exercises 225
Problems 234

Chapter 6
Intercompany Inventory Transactions 249

Inventory Transfers at Toys "R" Us 249
Overview of the Consolidated Entity and Intercompany Transactions 250
Elimination of Intercompany Transfers 251
Elimination of Unrealized Profits and Losses 251
Inventory Transactions 251
Consolidation Worksheet Elimination Entries 252
Transfers at Cost 252
Transfers at a Profit or Loss 252
Calculating Unrealized Profit or Loss 253
Deferring Unrealized Profit or Loss on the Parent's Books 256
Deferring Unrealized Profit or Loss in the Consolidation 256
Why Adjust the Parent's Books and Make Worksheet Eliminations for the Consolidated Financial Statements? 258
Effect of Type of Inventory System 259
Downstream Sale of Inventory 259
Resale in Period of Intercorporate Transfer 260
Resale in Period Following Intercorporate Transfer 261
Inventory Held for Two or More Periods 268
Upstream Sale of Inventory 268
Equity-Method Entries—20X1 269
Consolidation Worksheet—20X1 269
Consolidated Net Income—20X1 271
Equity-Method Entries—20X2 271
Consolidation Worksheet—20X2 272
Consolidated Net Income—20X2 274
Additional Considerations 274
Sale from One Subsidiary to Another 274
Costs Associated with Transfers 274
Lower of Cost or Market 274
Sales and Purchases before Affiliation 275
Summary of Key Concepts 275
Key Terms 276
APPENDIX 6A
Intercompany Inventory Transactions—Modified Equity Method and Cost Method 276
Questions 283
Cases 283
Exercises 285
Problems 293

Chapter 7
Intercompany Transfers of Noncurrent Assets and Services 307

Micron's Intercompany Fixed Asset Sale 307
Intercompany Long-Term Asset Transfers 308
Intercompany Transfers of Services 310
Intercompany Land Transfers 310
Overview of the Profit Elimination Process 310
Assignment of Unrealized Profit Elimination 312
Downstream Sale of Land 314
Upstream Sale of Land 318
Eliminating the Unrealized Gain after the First Year 322
Subsequent Disposition of the Asset 323
Intercompany Transfers of Depreciable Assets 324
Downstream Sale 324
Change in Estimated Life of Asset upon Transfer 332
Upstream Sale 332
Asset Transfers before Year-End 342
Intercompany Transfers of Amortizable Assets 342
Summary of Key Concepts 342
Key Terms 343
APPENDIX 7A
Intercompany Noncurrent Asset Transactions—Modified Equity Method and Cost Method 343
Questions 351
Cases 351
Exercises 353
Problems 361

Chapter 8
Intercompany Indebtedness 374

Ford's Debt Transfers 374
Consolidation Overview 375
Bond Sale Directly to an Affiliate 376
Transfer at Par Value 376
Transfer at a Discount or Premium 377
Bonds of Affiliate Purchased from a Nonaffiliate 379
Purchase at Book Value 380
Purchase at an Amount Less than Book Value 380
Purchase at an Amount Higher than Book Value 393
Summary of Key Concepts 395
Key Terms 395

APPPENDIX 8A
Intercompany Indebtedness—Fully Adjusted Equity Method Using Straight-Line Interest Amortization 395
APPPENDIX 8B
Intercompany Indebtedness—Modified Equity Method and Cost Method 410
Questions 417
Cases 418
Exercises 419
Problems 427

Chapter 9
Consolidation Ownership Issues 451

Berkshire Hathaway's Varied Investments 451
Subsidiary Preferred Stock Outstanding 452
Consolidation with Subsidiary Preferred Stock Outstanding 452
Subsidiary Preferred Stock Held by Parent 454
Subsidiary Preferred Stock with Special Provisions 457
Illustration of Subsidiary Preferred Stock with Special Features 458
Changes in Parent Company Ownership 460
Parent's Purchase of Additional Shares from Nonaffiliate 460
Parent's Sale of Subsidiary Shares to Nonaffiliate 463
Subsidiary's Sale of Additional Shares to Nonaffiliate 465
Subsidiary's Sale of Additional Shares to Parent 468
Subsidiary's Purchase of Shares from Nonaffiliate 470
Subsidiary's Purchase of Shares from Parent 472
Complex Ownership Structures 475
Multilevel Ownership and Control 475
Reciprocal or Mutual Ownership 480
Subsidiary Stock Dividends 483
Illustration of Subsidiary Stock Dividends 484
Impact on Subsequent Periods 485
Summary of Key Concepts 486
Key Terms 487
Questions 487
Cases 487
Exercises 489
Problems 496

Chapter 10
Additional Consolidation Reporting Issues 503

Advanced Consolidation Issues at Google 503
Consolidated Statement of Cash Flows 504
Preparation of a Consolidated Cash Flow Statement 504
Consolidated Cash Flow Statement Illustrated 504
Consolidated Cash Flow Statement—Direct Method 506
Consolidation Following an Interim Acquisition 507
Parent Company Entries 509
Consolidation Worksheet 509
Consolidation Income Tax Issues 512
Tax Allocation Procedures When Separate Tax Returns Are Filed 512
Allocation of Tax Expense When a Consolidated Return Is Filed 513
Tax Effects of Unrealized Intercompany Profit Eliminations 515
Consolidated Earnings per Share 519
Computation of Diluted Consolidated Earnings per Share 519
Computation of Consolidated Earnings per Share Illustrated 520
Summary of Key Concepts 522
Key Terms 523
Questions 523
Cases 524
Exercises 525
Problems 531

Chapter 11
Multinational Accounting: Foreign Currency Transactions and Financial Instruments 542

Microsoft's Multinational Business 542
Doing Business in a Global Market 543
The Accounting Issues 544
Foreign Currency Exchange Rates 545
The Determination of Exchange Rates 545
Direct versus Indirect Exchange Rates 545
Changes in Exchange Rates 547
Spot Rates versus Current Rates 549
Forward Exchange Rates 550
Foreign Currency Transactions 550
Foreign Currency Import and Export Transactions 552
Managing International Currency Risk with Foreign Currency Forward Exchange Financial Instruments 555
Derivatives Designated as Hedges 556
Forward Exchange Contracts 558
Case 1: Managing an Exposed Foreign Currency Net Asset or Liability Position: Not a Designated Hedging Instrument 560
Case 2: Hedging an Unrecognized Foreign Currency Firm Commitment: A Foreign Currency Fair Value Hedge 565
Case 3: Hedging a Forecasted Foreign Currency Transaction: A Foreign Currency Cash Flow Hedge 568
Case 4: Speculation in Foreign Currency Markets 570

Foreign Exchange Matrix 573
Additional Considerations 574
A Note on Measuring Hedge Effectiveness 574
Interperiod Tax Allocation for Foreign Currency Gains (Losses) 574
Hedges of a Net Investment in a Foreign Entity 574
Summary of Key Concepts 575
Key Terms 575
APPENDIX 11A
Illustration of Valuing Forward Exchange Contracts with Recognition for the Time Value of Money 575
APPENDIX 11B
Use of Other Financial Instruments by Multinational Companies 578
Questions 590
Cases 591
Exercises 592
Problems 603
Kaplan CPA Review 611

Chapter 12
Multinational Accounting: Issues in Financial Reporting and Translation of Foreign Entity Statements 612

McDonald's—The World's Fast Food Favorite 612
Convergence of Accounting Principles 614
Accounting for Differences in Currencies and Exchange Rates 616
Currency Definitions 616
Determination of the Functional Currency 617
Functional Currency Designation in Highly Inflationary Economies 619
Translation versus Remeasurement of Foreign Financial Statements 619
Translation of Functional Currency Statements into the Reporting Currency of the U.S. Company 622
Financial Statement Presentation of Translation Adjustment 622
Illustration of Translation and Consolidation of a Foreign Subsidiary 623
Noncontrolling Interest of a Foreign Subsidiary 634
Remeasurement of the Books of Record into the Functional Currency 634
Statement Presentation of Remeasurement Gain or Loss 636
Illustration of Remeasurement of a Foreign Subsidiary 636
Proof of Remeasurement Exchange Gain 638
Remeasurement Case: Subsequent Consolidation Worksheet 639
Summary of Translation versus Remeasurement 641
Additional Considerations in Accounting for Foreign Operations and Entities 641
Foreign Investments and Unconsolidated Subsidiaries 641
Liquidation of a Foreign Investment 643
Hedge of a Net Investment in a Foreign Subsidiary 643
Disclosure Requirements 644
Statement of Cash Flows 645
Lower-of-Cost-or-Market Inventory Valuation under Remeasurement 645
Intercompany Transactions 645
Income Taxes 647
Translation When a Third Currency Is the Functional Currency 647
Summary of Key Concepts 648
Key Terms 648
Questions 648
Cases 649
Exercises 653
Problems 663
Kaplan CPA Review 673

Chapter 13
Segment and Interim Reporting 674

Segment Reporting at Walmart 674
Reporting for Segments 675
Segment Reporting Accounting Issues 675
International Financial Reporting Standards for Operating Segments 675
Information about Operating Segments 676
Defining Reportable Segments 676
Comprehensive Disclosure Test 682
Reporting Segment Information 683
Enterprisewide Disclosures 684
Information about Products and Services 684
Information about Geographic Areas 685
Information about Major Customers 686
Interim Financial Reporting 686
The Format of the Quarterly Financial Report 686
Accounting Issues 687
Accounting Pronouncements on Interim Reporting 687
International Financial Reporting Standards for Interim Reporting 687
Reporting Standards for Interim Income Statements 688
Revenue 688
Cost of Goods Sold and Inventory 689
All Other Costs and Expenses 692
Accounting for Income Taxes in Interim Periods 694

Disposal of a Component of the Entity or Extraordinary, Unusual, Infrequently Occurring, and Contingent Items 698
Accounting Changes in Interim Periods 698
Change in an Accounting Principle (Retrospective Application) 698
Change in an Accounting Estimate (Current and Prospective Application) 699
Change in a Reporting Entity (Retrospective Application) 699
International Financial Reporting Standards for Accounting Changes 700
Summary of Key Concepts 700
Key Terms 700
Questions 700
Cases 701
Exercises 705
Problems 714

Chapter 14
SEC Reporting 722

The Genesis of Securities Regulation 722
International Harmonization of Accounting Standards for Public Offerings 723
Securities and Exchange Commission 724
Organizational Structure of the Commission 724
Laws Administered by the SEC 725
The Regulatory Structure 725
Issuing Securities: The Registration Process 728
The Registration Statement 729
SEC Review and Public Offering 729
Accountants' Legal Liability in the Registration Process 730
Periodic Reporting Requirements 730
Accountants' Legal Liability in Periodic Reporting 733
Electronic Data Gathering, Analysis, and Retrieval (EDGAR) System 733
Foreign Corrupt Practices Act of 1977 734
Sarbanes-Oxley Act of 2002 734
Title I: Public Company Accounting Oversight Board 734
Title II: Auditor Independence 735
Title III: Corporate Responsibility 735
Title IV: Enhanced Financial Disclosures 736
Title V: Analyst Conflicts of Interest 736
Title VI: Commission Resources and Authority 736
Title VII: Studies and Reports 736
Title VIII: Corporate and Criminal Fraud Accountability 736
Title IX: White-Collar Crime Penalty Enhancements 737
Title X: Sense of Congress Regarding Corporate Tax Returns 737
Title XI: Corporate Fraud and Accountability 737
Disclosure Requirements 737
Management Discussion and Analysis 737
Pro Forma Disclosures 738
Summary of Key Concepts 739
Key Terms 739
Questions 739
Cases 740
Exercises 743

Chapter 15
Partnerships: Formation, Operation, and Changes in Membership 749

The Evolution of PricewaterhouseCoopers (PwC) 749
The Nature of the Partnership Entity 750
Legal Regulation of Partnerships 750
Definition of a Partnership 751
Formation of a Partnership 751
Other Major Characteristics of Partnerships 752
Accounting and Financial Reporting Requirements for Partnerships 754
International Financial Reporting Standards for Small and Medium-Size Entities and Joint Ventures 755
Accounting for the Formation of a Partnership 755
Illustration of Accounting for Partnership Formation 756
Accounting for the Operations of a Partnership 757
Partners' Accounts 757
Allocating Profit or Loss to Partners 758
Illustrations of Profit Allocation 759
Multiple Profit Allocation Bases 762
Special Profit Allocation Methods 763
Partnership Financial Statements 763
Changes in Membership 764
General Concepts to Account for a Change in Membership in the Partnership 764
New Partner Purchases Partnership Interest Directly from an Existing Partner 766
New Partner Invests in Partnership 768
Determining a New Partner's Investment Cost 781
Dissociation of a Partner from the Partnership 781
Summary of Key Concepts 784
Key Terms 784
APPENDIX 15A
Tax Aspects of a Partnership 784
APPENDIX 15B
Joint Ventures 786
Questions 788
Cases 788
Exercises 790
Problems 797

Chapter 16
Partnerships: Liquidation 804

The Demise of Laventhol & Horwath 804
Overview of Partnership Liquidations 805
Dissociation, Dissolution, Winding-Up, and Liquidation of a Partnership 805
Lump-Sum Liquidations 807
Realization of Assets 807
Liquidation Expenses 807
Illustration of a Lump-Sum Liquidation 807
Installment Liquidations 812
Illustration of Installment Liquidation 813
Cash Distribution Plan 817
Additional Considerations 820
Incorporation of a Partnership 820
Summary of Key Concepts 821
Key Terms 821
APPENDIX 16A
Partners' Personal Financial Statements 821
Questions 824
Cases 825
Exercises 826
Problems 836

Chapter 17
Governmental Entities: Introduction and General Fund Accounting 842

Accounting for the Bustling City of San Diego 842
Differences between Governmental and Private Sector Accounting 843
History of Governmental Accounting 844
Major Concepts of Governmental Accounting 845
Elements of Financial Statements 845
Expendability of Resources versus Capital Maintenance Objectives 846
Definitions and Types of Funds 846
Financial Reporting of Governmental Entities 848
Fund-Based Financial Statements: Governmental Funds 849
Measurement Focus and Basis of Accounting (MFBA) 852
Basis of Accounting—Governmental Funds 853
Basis of Accounting—Proprietary Funds 856
Basis of Accounting—Fiduciary Funds 856
Budgetary Aspects of Governmental Operations 857
Recording the Operating Budget 857
Accounting for Expenditures 858
The Expenditure Process 858
Classification of Expenditure Transactions and Accounts 860
Outstanding Encumbrances at the End of the Fiscal Period 861
Expenditures for Inventory 864
Accounting for Fixed Assets 866
Long-Term Debt and Capital Leases 867
Investments 868
Interfund Activities 868
(1) Interfund Loans 869
(2) Interfund Services Provided and Used 869
(3) Interfund Transfers 870
(4) Interfund Reimbursements 870
Overview of Accounting and Financial Reporting for the General Fund 871
Comprehensive Illustration of Accounting for the General Fund 871
Adoption of the Budget 872
Property Tax Levy and Collection 873
Other Revenue 874
Expenditures 875
Acquisition of Capital Asset 875
Interfund Activities 876
Adjusting Entries 876
Closing Entries 877
General Fund Financial Statement Information 878
Summary of Key Concepts 881
Key Terms 881
Questions 882
Cases 882
Exercises 884
Problems 893

Chapter 18
Governmental Entities: Special Funds and Government-wide Financial Statements 901

Governmental Accounting in Maryland 901
Summary of Governmental Fund Types 903
Governmental Funds Worksheets 904
Special Revenue Funds 904
Capital Projects Funds 908
Illustration of Transactions 908
Financial Statement Information for the Capital Projects Fund 911
Debt Service Funds 911
Illustration of Transactions 912
Financial Statement Information for the Debt Service Fund 914
Permanent Funds 914
Illustration of Transactions 914
Governmental Funds Financial Statements 915
Enterprise Funds 918
Illustration of Transactions 919
Financial Statements for the Proprietary Funds 921
Internal Service Funds 923
Illustration of Transactions 924
Financial Statements for Internal Service Funds 926

Trust Funds 926
Illustration of Private-Purpose Trust Fund 927
Agency Funds 928
Illustration of Transactions in an Agency Fund 929
The Government Reporting Model 929
Four Major Issues 929
Government Financial Reports 931
Government-wide Financial Statements 932
Reconciliation Schedules 934
Budgetary Comparison Schedule 936
Management's Discussion and Analysis 938
Notes to the Government-wide Financial Statements 938
Other Financial Report Items 939
Interim Reporting 939
Auditing Governmental Entities 939
Additional Considerations 940
Special-Purpose Governmental Entities 940
Summary of Key Concepts 940
Key Terms 941
APPENDIX 18A
Other Governmental Entities—Public School Systems and the Federal Government 941
Questions 943
Cases 943
Exercises 945
Problems 956

Chapter 19
Not-for-Profit Entities 968

United Way Worldwide 968
Financial Reporting for Private, Not-for-Profit Entities 969
Important FASB Standards for Not-for-Profit Entities 970
Colleges and Universities 973
Special Conventions of Revenue and Expenditure Recognition 973
Board-Designated Funds 974
Public Colleges and Universities 974
Private Colleges and Universities 974
Health Care Providers 975
Hospital Accounting 977
Financial Statements for a Not-for-Profit Hospital 981
Comprehensive Illustration of Hospital Accounting and Financial Reporting 985
Temporarily Restricted Funds 993
Summary of Hospital Accounting and Financial Reporting 996
Voluntary Health and Welfare Organizations 996
Accounting for a VHWO 997
Financial Statements for a VHWO 997
Summary of Accounting and Financial Reporting for VHWOs 1007
Other Not-for-Profit Entities 1007
Accounting for an ONPO 1007
Financial Statements of an ONPO 1007
Summary of Accounting and Financial Reporting for an ONPO 1010
Summary of Key Concepts 1011
Key Terms 1011
Questions 1011
Cases 1012
Exercises 1015
Problems 1025

Chapter 20
Corporations in Financial Difficulty 1039

GM in Financial Distress 1039
Courses of Action 1041
Nonjudicial Actions 1041
Judicial Actions 1042
Chapter 11 Reorganizations 1043
Fresh Start Accounting 1045
Plan of Reorganization 1046
Illustration of a Reorganization 1046
Chapter 7 Liquidations 1054
Classes of Creditors 1054
Secured Creditors 1054
Creditors with Priority 1054
General Unsecured Creditors 1056
Statement of Affairs 1056
Additional Considerations 1057
Trustee Accounting and Reporting 1057
Summary of Key Concepts 1062
Key Terms 1063
Questions 1063
Cases 1063
Exercises 1065
Problems 1068

INDEX 1073

Chapter One

Intercorporate Acquisitions and Investments in Other Entities

Multi-Corporate Entities

Business Combinations

Consolidation Concepts and Procedures

Intercompany Transfers

Additional Consolidation Issues

Multinational Entities

Reporting Requirements

Partnerships

Governmental and Not-for-Profit Entities

Corporations in Financial Difficulty

KRAFT'S ACQUISITION OF CADBURY

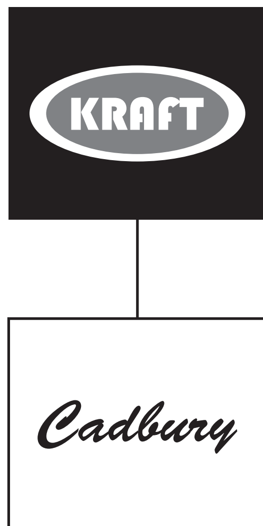
In recent years as well as during the past several decades, the business world has witnessed many corporate acquisitions and combinations, often involving some of the world's largest and best-known companies. Some of these combinations have captured public attention because of the personalities involved, 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 really the next step in more than a century of regular acquisitions.

In 1896, inspired in part by his time in the Kellogg brothers' Battle Creek Sanitarium, C.W. Post founded Postum Cereal Company, Ltd. The following year he introduced Grape-Nuts brand cereal. Within five years, Postum employed 2,500 people and its Battle Creek facility was the largest of its kind in the world.

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.

These two start-up companies (Kraft and Postum) continued to grow independently. Postum went public in 1922, followed by Kraft in 1924. In 1929, Postum changed its name to General Foods Corporation and in 1930, Kraft was acquired by National Dairy Products. In 1937, Kraft launched its well-known macaroni and cheese dinners. By 1953, business was booming for General Foods, and it acquired Perkins Products, maker of Kool-Aid. In 1981, General Foods made another acquisition, this time acquiring Oscar Mayer & Co.

Philip Morris acquired General Foods in 1985 and Kraft in 1988. A year later, General Foods and Kraft were combined 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. The story does not end here. In August 2008, the Post Cereal portion of Kraft was spun 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. Cadbury took its own journey. It took 104 years and dozens of mergers and acquisitions to finally end up with the companies that took part in this acquisition.

At the time of this writing, a mere eighteen months following the Cadbury acquisition, Kraft announced plans to spin off its $32 billion snack business by the end of 2012. This spin-off would separate the high-growth snack business from the North American grocery business ($16 billion in annual sales), which is focused in more mature markets. Analysts suggest that this spin-off will allow Kraft to separate two very distinct businesses that face different opportunities and challenges.

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

LO 1-3 Make calculations and prepare journal entries for the creation and purchase 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 any of a variety of forms of 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 and on selected other types of investments in and relationships with other entities. Moreover, it introduces basic concepts associated with the preparation of ***consolidated financial statements*** that portray the related companies as if they were actually a single company. 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. When orders for commercial airliners plummeted following a precipitous decline in air travel, increased defense spending, partially related to the war in Iraq, 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 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 to incorporate separately part of the ongoing operations previously conducted within the parent company. Other subsidiaries are acquired through business combinations.

Business combinations are a continuing and frequent part of the business environment. 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 (when an acquiring company borrows the funds to buy another company), but the resulting debt has plagued many of those companies over the years.

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

[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.

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. 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]

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 in a relatively short time. This activity was slowed dramatically by the credit crunch of 2007–2008. Nevertheless, business combinations 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, LBO
1992–2000	Fifth Wave	Cross-border mergers
2003–2008	Sixth Wave	Shareholder activism, private equity, LBO

Source: Martin Lipton, "Merger Waves in the 19th, 20th and 21st Centuries," *The Davies Lecture*, York University, September 14, 2006."

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

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

one created for a single specified purpose. An SPE may be in the form of a corporation, trust, or partnership. Enron Corp., 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.

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

The scandals and massive accounting failures at companies such as Enron, WorldCom, and Tyco—leading 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.

BUSINESS EXPANSION AND FORMS OF ORGANIZATIONAL STRUCTURE

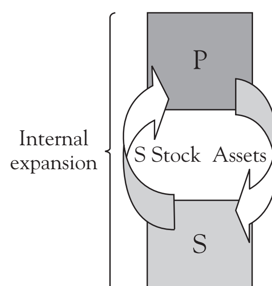
Historically, businesses have expanded by internal growth through new product development and expansion of existing product lines into new markets. In recent decades, however, many companies have chosen to expand by combining with or acquiring other companies. Either approach may lead to a change in 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, and, in exchange, the transferring company receives equity ownership (as illustrated in the diagram on the next page).

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 in disposing of a segment of operations that no longer fits well with the overall 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. Although a transfer of ownership to one or more unrelated parties normally results in a taxable transaction, properly designed transfers of ownership to existing shareholders generally qualify as nontaxable exchanges.

FYI

As of this writing (March 2012), Kraft is planning to spin off its $32 billion snack business, presumably as a means of allowing Kraft to focus on its grocery business and other strategic goals.

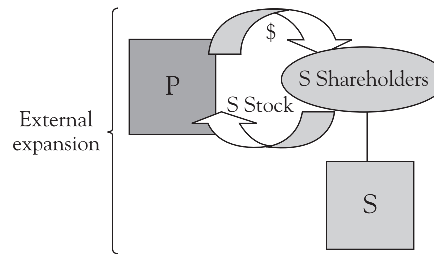
External Expansion: Business Combinations

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 combination*** occurs when ". . . an acquirer obtains control of one or more businesses."[4] The diagram on the next 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.

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.

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



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 company'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 company.
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 company. 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 for the investment 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 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, will be discussed throughout the first 10 chapters of the text. The primary focus will be 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 will be limited because of its complexity and the diversity of these contractual arrangements.

[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.

THE DEVELOPMENT OF ACCOUNTING FOR BUSINESS COMBINATIONS

LO 1-2

Understand the history of 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 decade. 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 method. Thus, a general understanding of this method 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 and purchase of a business entity.

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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.

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

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

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*	110,000	
	Cash		70,000
	Inventory		50,000
	Land		75,000
	Building		100,000
	Equipment		250,000

Record the creation of Blaine Company.
*$110,000 = ($100,000 − $80,000) + ($250,000 − $160,000)

[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.