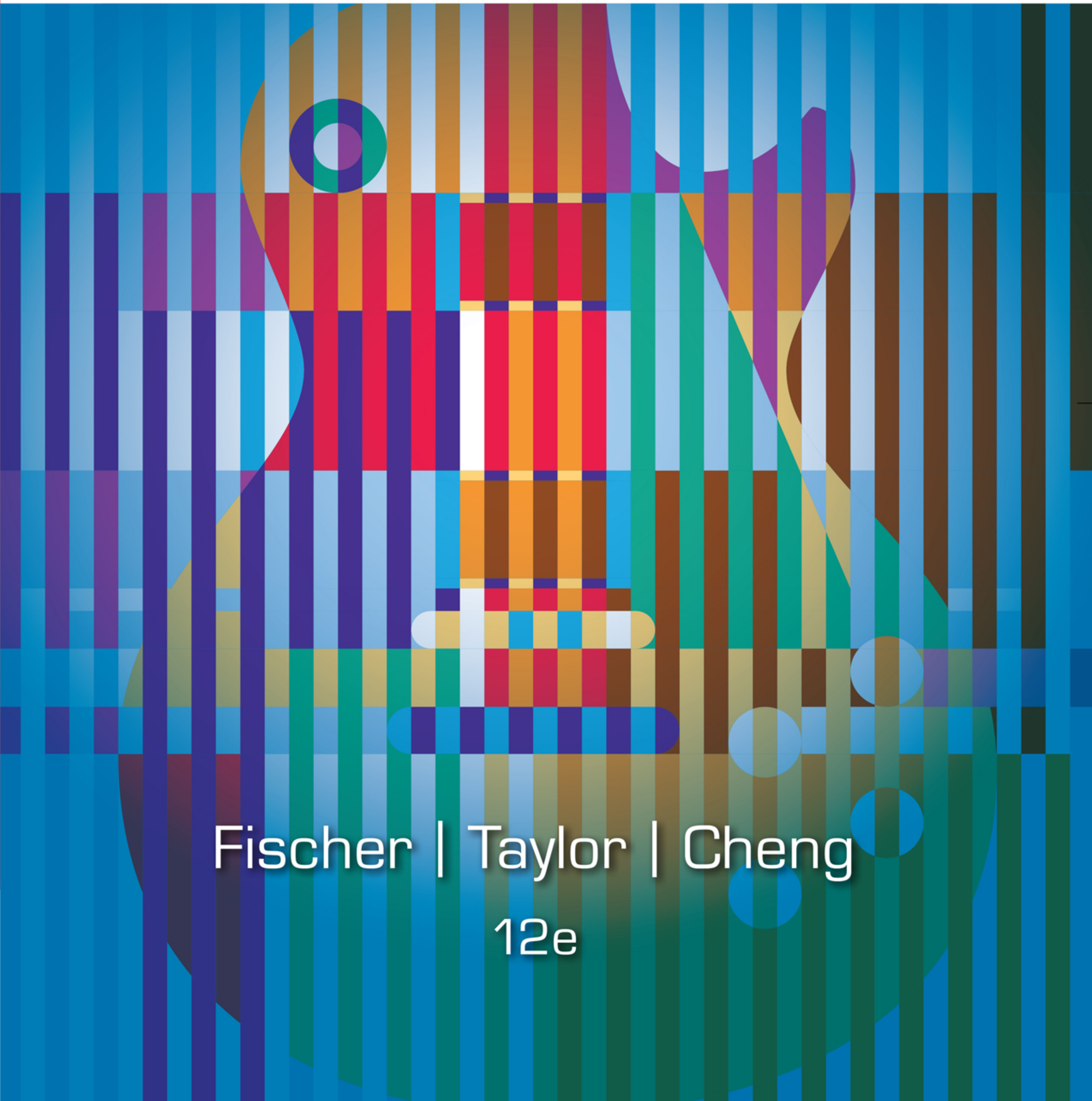
Advanced Accounting



Fischer | Taylor | Cheng

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Advanced Leadership

PREFACE

INNOVATION

The twelfth edition of *Advanced Accounting* raises the standard in accounting education. Providing the most innovative, up-to-date, and comprehensive coverage of advanced financial accounting topics on the market today, this edition incorporates pedagogically strong elements throughout. The end result is a valuable and useful resource for both the present and the future. Fischer/Taylor/Cheng's *Advanced Accounting* offers the learner the ability to understand, and then to apply, new knowledge like no other advanced accounting text available. Leading the way are these unique, innovative, and helpful features:

- **Understanding and applying the new Financial Accounting Standards Board codification terms:**

  - Coverage of International Financial Reporting Standards (IFRS).
  - References throughout have been updated to reflect codification terms.
  - All subsidiary accounts are adjusted to full fair value whenever control is achieved. The noncontrolling interest is adjusted to fair value.
  - Instead of allocating the available amount to fixed assets in a bargain purchase, all accounts are recorded at full fair value and the bargain results in a gain.
  - Changes in the parent's ownership interest are treated as equity transactions with no impact on income.
  - Changes in the subsidiary's equity are treated as equity transactions with no impact on income.

- **Excelling with ease—easy-to-follow Excel® tutorials and convenient electronic working papers available on the text's Web site (www.cengagebrain.com):**

  - This unique tutorial teaches a step-by-step process for completing consolidations worksheets in an Excel-based environment. The tutorial makes it possible to master consolidations worksheets more quickly.
  - The tutorial guides the student through the creation of Excel worksheets. Each chapter of the tutorial adds the consolidations processes to parallel those presented in Chapters 1–6 of the text.
  - The electronic working papers in Excel format provide students with the basic worksheet structure for selected assignments throughout the text. These assignments are identified in the text by the icon shown here.

- **Comprehending through consistency—common coding for the worksheets:**

  - All consolidations worksheets use a common coding for the eliminations and adjustments. A complete listing of the codes is presented on the inside of the front cover. Students are now able to quickly recall worksheet adjustments as they move from one chapter to the next.
  - Within the chapter narrative, the worksheet eliminations and adjustments are shown in journal entry form and are referenced using the same coding. This provides consistent

reinforcement of the consolidations process and aids students in their understanding of the worksheet procedures. An example follows:

(CY1)	Eliminate current-year equity income:		
	Subsidiary Income	60,000	
	Investment in Company S		60,000
(EL)	Eliminate 80% of subsidiary equity against investment in subsidiary account:		
	Common Stock ($10 par)—Company S	80,000	
	Retained Earnings, January 1, 2011—Company S	56,000	
	Investment in Company S		136,000
(IS)	Eliminate intercompany merchandise sales:		
	Sales	100,000	
	Cost of Goods Sold		100,000

- The same codes are continued in the Excel tutorial and the worksheet solutions.

- **Taming a tough topic—coverage of derivatives and related accounting issues in a module:**
  - A comprehensive module deals with derivative instruments and related accounting issues. This module, located just before Chapter 10, sets forth the basic characteristics of derivative financial instruments and explains the features of common types of derivatives. Accounting for derivatives held as an investment and as a part of a hedging strategy is discussed. Although covering the derivatives module prior to Chapter 10 is recommended, Chapter 10 can be taught without coverage of the derivatives module.
  - Fair value and cash flow hedges are clearly defined, and the special accounting given such hedges is set forth in a clear and concise manner. Options, futures, and interest rate swaps are used to demonstrate accounting for fair value hedges and cash flow hedges.
  - New explanations, examples, and end-of-chapter problems have been added to help simplify this complex topic.
  - The more complex issues that are associated with the use of forward contracts are introduced in the module and then fully addressed in Chapter 10. Thus, Chapter 10's discussion of hedging foreign currency transactions is more streamlined and less cumbersome.
  - Most of the chapter's discussion of hedging foreign currency transactions involves the use of forward contracts. The focus is on the use of such contracts to hedge foreign currency transactions, commitments, and forecasted transactions.

- **Accounting for change—coverage of government reporting model and estate tax planning:**
  - Comprehensive coverage of governmental standards through GASB Statement No. 71, including the historic changes to the reporting model.
  - Government and not-for-profit chapters include material for CPA Exam preparation.
  - Chapters are designed for use in advanced accounting courses or in standalone governmental and not-for-profit courses.

1
OBJECTIVE

Explain why transactions between members of a consolidated firm should not be reflected in the consolidated financial statements.

- **Measuring student mastery—Learning Objectives:**
  - Each chapter begins with a list of measurable learning objectives, which are repeated in the margin near the related coverage.
  - The exercises and problems at the end of the chapter indicate the specific learning objectives that they reinforce. This helpful indicator, along with the assignment titles, provides a quick reference for both student and instructor.

- **Staying up to date—IASB Perspectives:**
  - Within relevant chapters, a new box feature provides information and commentary regarding how standards differ between U.S. GAAP and IFRS.
  - This feature provides students with a clear understanding as to how IASB proposals may differ and what questions to consider moving forward with their studies.

IASB PERSPECTIVES

- IFRS considers potential voting rights if they are currently exercisable, in measuring control, while GAAP does not.
- IFRS also allows consolidation when there is "de facto" control. This is a situation in which there is only one large stockholder that owns less than 50% of the shares, but other share holdings are disbursed and the owners do not generally exercise their voting rights. This is similar to the SEC position indicated above.

- **Communicating the core content—Reflection:**
  - Concluding every main section is a reflection on the core information contained in that section.
  - These reflections provide students with a clear picture of the key points they should grasp and give them a helpful tool for quick review.

REFLECTION

- The combining of the statements of a parent and its subsidiaries into consolidated statements is required when parent ownership exceeds 50% of the controlled firm's shares.
- Consolidation is required for any company that is controlled, even in cases where less than 51% of the company's shares is owned by the parent.

- **Thinking it through—Understanding the Issues:**
  - These questions at the end of the chapter emphasize and reinforce the core issues of the chapter.

UNDERSTANDING THE ISSUES

1. A parent company paid $500,000 for a 100% interest in a subsidiary. At the end of the first year, the subsidiary reported net income of $40,000 and paid $5,000 in dividends. The price paid reflected understated equipment of $70,000, which will be amortized over 10 years. What would be the subsidiary income reported on the parent's unconsolidated income statement, and what would the parent's investment balance be at the end of the first year under each of these methods?

   a. The simple equity method
   b. The sophisticated equity method
   c. The cost method

2. What is meant by date alignment? Does it exist on the consolidated worksheet under the following methods, and if not, how is it created prior to elimination of the investment account under each of these methods?

   a. The simple equity method
   b. The sophisticated equity method
   c. The cost method

- They encourage students to think in greater depth about the topics and expand their reasoning skills. Discussion skills are also developed through use of the questions as springboards for class interaction.

THEORY BLENDED WITH APPLICATION

With a strong tradition of combining sound theoretical foundations with a hands-on, learn-by-example approach, the twelfth edition continues its prominent leadership position in advanced accounting classrooms across the country. The authors build upon *Advanced Accounting*'s clear writing style, comprehensive coverage, and focus on conceptual understanding.

Realizing that students reap the greatest benefits when they can visualize the application of theories, *Advanced Accounting* closely links theory and practice by providing examples through relevant exhibits and tables that are common to real-world accounting. When students can visualize the concept being discussed and apply it directly to an example, their understanding greatly improves. This focus on conceptual understanding makes even the most complex topics approachable.

Assignments are clearly defined. End-of-chapter questions are used to reinforce theory, and exercises are short, focused applications of specific topics in the chapter. These exercises are very helpful when students use them as preparation for possible class presentations. The book's problems, which are designed to be more comprehensive than the exercises, often combine topics and are designed to work well as after-class assignments. For group projects, the cases found in the business combinations chapters provide an innovative way to blend theoretical and numerical analysis.

ENHANCED COVERAGE

Advanced Accounting reflects changes in accounting procedures and standards while improving on those features that aid in student comprehension.

- **Chapter 1**
  - New material on Goodwill including ability of non-public companies to amortize goodwill and new impairment procedures for goodwill.
  - Expanded coverage of contingent consideration in the purchase of a business.

- **Chapter 2**
  - New, simplified procedure for valuation schedule that covers all potential situations.
  - Introduction of Variable Interest Entities (VIE) as another application of consolidation procedures.
  - Expanded and updated coverage of reverse acquisitions.

- **Chapter 3**
  - New information on disclosure for an intraperiod purchase.

- **Chapter 4**
  - Updated end-of-chapter material.

- **Chapter 5**
  - Updated end-of-chapter material.

- **Chapter 6**
  - Improved coverage of amortizations of excess cost as they impact cash flow statement.
  - Section on nonconsolidated investments has been moved to an appendix.
  - Updated consolidated statement of cash flows example.
  - Revised coverage of consolidated earnings per share.
  - Revised coverage of taxation of consolidated companies including foreign subsidiaries.

- **Chapter 7**
  - Updated coverage on sale of parent interest in a subsidiary.

- **Chapter 8**
  - Revised discussion of subsidiary stock dividends.
  - New section called "Parent Company Shares Purchased by Subsidiary."
  - Section on stick swap has been removed.
  - The reciprocal method of consolidating ownership of parent shares by the subsidiary has been eliminated.

- **Special Appendix 1: Accounting for Influential Investments**
  - Revised content to reflect current FASB Codification updates.
  - Updated section called "Fair Value Option."
  - Updated end-of-appendix material.

- **Special Appendix 2: Variable Interest Entities**
  - Defining a VIE.
  - Application of the consolidations model to a VIE.

- **Chapter 9**
  - Updated discussion of the scale of international activity and how it relates to foreign currency transactions, foreign currency translation, and international standard setting.
  - Added coverage of the current positions of the Financial Accounting Standards Board (FASB), the International Accounting Standards Board (IASB), and the Securities and Exchange Commission (SEC) regarding convergence to IFRS.

- **Chapter 10**
  - Simplified entries necessary to account for derivatives.
  - Revised end-of-chapter materials place a greater focus on the impact of hedging on both financial position and operating results.
  - Updated coverage of highlights of the IASB's proposed standard on hedging are set forth in the "IASB Perspectives" feature.

- **Chapter 11**
  - New illustration of the consolidation of a U.S. parent and a foreign subsidiary.
  - Incorporated new standards as they relate to consolidations.

- **Chapter 12**
  - End-of-chapter materials have been updated and revised.
  - All footnotes have been changed to reference relevant sections of the Accounting Standards Codification (ASC).

- **Chapter 13**
  - End-of-chapter materials have been updated and revised.
  - All footnotes have been changed to reference relevant sections of the Accounting Standards Codification.

- **Chapter 14**
  - End-of-chapter materials have been updated and revised.
  - All footnotes have been changed to reference relevant sections of the Accounting Standards Codification.

- **Chapter 15**
  - Include a discussion of deferred inflows of resources and deferred outflows of resources.
  - Updated entries for examples.
  - Updated end-of-chapter material.

- **Chapter 16**
  - Updated entries for examples.
  - Updated end-of-chapter material.

- **Chapter 17**
  - Updated entries for examples.
  - Updated end-of-chapter material.

- **Chapter 18**
  - Updated entries for examples.
  - Updated end-of-chapter material.

- **Chapter 19**
  - Updated entries for examples.
  - Updated end-of-chapter material.

- **Chapter 20**
  - Revised exclusions and rates are employed and an explanation for this logic is set forth at the beginning of the chapter.
  - Updated pedagogical aspects of accounting for estates and trusts are firmly set forth.
  - Updated website material is conveyed regarding Congressional actions concerning estate taxation (www.cengagebrain.com).

- **Chapter 21**
  - End-of-chapter materials have been updated and revised.
  - All footnotes have been changed to reference relevant sections of the Accounting Standards Codification.

- **Appendix**
  - Applies the equity method to nonconsolidated (influential) investments.
  - Updated coverage includes the fair value option.

FLEXIBILITY

The book's flexible coverage of topics allows for professors to teach the course at their own pace and in their preferred order. There are no dependencies between major sections of the text except that coverage of consolidations should precede multinational accounting if one is to understand accounting for foreign subsidiaries. It is also advisable that students master the module on derivatives before advancing to the chapter on foreign currency transactions. The book contains enough coverage to fill two advanced courses, but when only one semester is available, many professors find it ideal to cover the first four to six chapters in business combinations.

The text is divided into the following major topics:

Business Combinations—Basic Topics (Chapters 1–6)

Chapter 1 demonstrates the FASB rules for assigning the cost of an acquired company to its assets and liabilities. Goodwill impairment replaces amortization and is fully explained.

Chapters 2 through 5 cover the basics of preparing a consolidated income statement and balance sheet. In 1977, we introduced two schedules that have been much appreciated by students and faculty alike—the determination and distribution of excess schedule and income distribution schedule. The determination and distribution schedule (quickly termed the D&D schedule by students) analyzes the difference between the fair value of the acquired company and the underlying equity of the subsidiary. The D&D schedule has been reconfigured to revalue the entire company, including the noncontrolling interest. It provides a check figure for all subsequent years' worksheets, details all information for the distribution of differences between book and fair values, and reveals all data for the amortization of the differences. The schedule provides rules for all types of acquisition situations. The income distribution schedule (known as the IDS) is a set of T accounts that distributes income between the noncontrolling and controlling interests. It also provides a useful check function to ensure that all intercompany eliminations are properly accounted for. These chapters give the student all topics needed for the CPA Exam. (For easy reference, the text contains a callout in the margin, as shown here, that ties the narrative to the worksheets. In addition, the related narrative pages are indicated in the upper right side of each worksheet. This allows the reader to quickly locate important explanations.)

Worksheet 3-1: page 150

With regard to the alternative worksheet methods and why we follow the approaches we do, consider the method used to record the investment in the subsidiary's and the parent's books. There are two key points of general agreement. The first is that it doesn't really matter which method is used, since the investment account is eliminated. Second, when the course is over, a student should know how to handle each method: simple equity, full (we call it sophisticated) equity, and cost. The real issue is which method is the easiest one to learn first. We believe the winner is simple equity, since it is totally symmetric with the equity accounts of the subsidiary. It simplifies elimination of subsidiary equity against the investment account. Every change in subsidiary equity is reflected, on a pro rata basis, in the parent's investment account. Thus, the simple equity method becomes the mainline method of the text. We teach the student to convert investments maintained under the cost method to the simple equity method. In practice, most firms and the majority of the problems in the text use the cost method. This means that the simple equity method is employed to solve problems that begin as either simple equity or cost method problems.

We also cover the sophisticated equity method, which amortizes the excess of cost or book value through the investment account. This method should also adjust for intercompany profits through the investment account. The method is cumbersome because it requires the student to deal with amortizations of excess and intercompany profits in the investment account before getting to the consolidated worksheet, which is designed to handle these topics. This means teaching consolidating procedures without the benefit of a worksheet. We cover the method after the student is proficient with a worksheet and the other methods. Thorough understanding of the sophisticated method is important so that it can be applied to influential investments that are not consolidated. (This is covered in the Appendix.)

Another major concern among advanced accounting professors has to do with the worksheet style used. There are three choices: the horizontal (trial balance) format, the vertical (stacked) method, and the balance sheet only. Again, we do cover all three, but the horizontal format is our main method. Horizontal is by far the most appealing to students. They have used it in both introductory and intermediate accounting. It is also the most likely method to be found in practice. On this basis, we use it initially to develop all topics. We cover the vertical format but not until the student is proficient with the horizontal format. There is no difference in the elimination procedures; only the worksheet logistics differ. It takes only one problem assignment to teach the students this approach so they are prepared for its possible appearance on the CPA Exam. The balance-sheet-only format has no reason to exist other than its use as a CPA Exam testing shortcut. We cover it in the Appendix.

Chapter 6 may be more essential for those entering practice than it is for the CPA Exam. It contains cash flow for consolidated firms, consolidated earnings per share, and taxation issues. Support schedules guide the worksheet procedures for consolidated companies, which are taxed as separate entities. Taxation is the most difficult application of consolidation procedures. Every intercompany transaction is a tax allocation issue. Teaching the tax allocation issues with every topic as it is introduced is very confusing to students. We prefer to have the students fully understand worksheet procedures without taxes and then introduce taxes.

Business Combinations—Specialized Topics (Chapters 7 and 8)

These chapters deal with topics that occasionally surface in practice and have seldom appeared on the CPA Exam. Studying these chapters perfects the students' understanding of consolidations and stockholders' equity accounting, thus affording a valuable experience. Chapter 7 deals with piecemeal acquisitions of an investment in a subsidiary, sale of the parent's investment, and the impact of preferred stock in the subsidiary's equity structure. Chapter 8 deals with the impact of subsidiary equity transactions including stock dividends, sale of common stock shares, and subsidiary reacquisitions of shares. The chapter also considers indirect or three-tier ownership structures and reciprocal holdings where the subsidiary owns parent shares.

Accounting for equity method investments is located in the Appendix that follows Chapter 8. The methods used for consolidations are adapted to influential investments. The IDS schedule used to distribute consolidated net income is used to calculate investment income.

Multinational Accounting and Other Reporting Concerns (Chapters 9–11 and Module)

As business has developed beyond national boundaries, the discipline of accounting also has evolved internationally. As our global economy develops, so, too, does the demand for reliable and comparable financial information. Chapter 9 discusses the international accounting environment and current efforts to converge U.S. generally accepted accounting principles with international standards.

The use of derivative financial instruments and the related accounting is a very complex subject that is discussed in a separate module. The principles set forth in FASB Codification are set forth in a clear manner. The module may be used to support a standalone topic dealing with derivatives or as a preface to the multinational chapter dealing with foreign currency transactions. Regardless of how one chooses to use the module, students will benefit from an understanding of this important topic. The nature of derivatives is discussed along with a more in-depth look at the common types of derivative instruments. The basic accounting for derivatives held as an investment is illustrated. Options, futures, and interest rate swaps are used for illustrative purposes. The accounting for derivatives that are designated as a hedge is illustrated for both fair value and cash flow hedges. More specifically, the use of a derivative to hedge a recognized transaction (asset or liability), an unrecognized firm commitment, or a forecasted transaction is discussed and illustrated. Throughout the module, illustrative entries and graphics are used to improve the students' understanding of this topic.

Chapter 10 discusses the accounting for transactions that are denominated or settled in a foreign currency. Following this discussion, the hedging of such transactions with the use of forward contracts is introduced. Hedging foreign currency recognized transactions, unrecognized firm commitments, and forecasted transactions is discussed in order to illustrate the business purpose and special accounting associated with such hedging strategies in an international setting. The chapter is not overly complicated, given the fact that the concept of hedging and the special accounting given hedges have already been discussed in a separate module on derivatives and related accounting issues.

Chapter 11 demonstrates the remeasurement and/or translation of a foreign entity's financial statements into a U.S. investor's currency. Wherever possible, examples of footnote disclosure relating to international accounting issues are presented.

The usefulness of financial information naturally increases if it is communicated on a timely basis. Therefore, interim financial statements and reporting requirements are now widely accepted. In Chapter 12, the concept of an interim period as an integral part of a larger annual accounting period is set forth as a basis for explaining the specialized accounting principles of interim reporting. Particular attention is paid to the determination of the interim income tax provision including the tax implications of net operating losses. Chapter 12 also examines segmental reporting and the various disclosure requirements. A worksheet format for developing segmental data is used, and students are able to review the segmental footnote disclosure for a large public company.

Accounting for Partnerships (Chapters 13 and 14)

Chapters 13 and 14 take students through the entire life cycle of a partnership, beginning with formation and ending in liquidation. Although new forms of organization such as the limited liability corporation are available, partnerships continue to be a common form of organization. Practicing accountants must be aware of the characteristics of this form of organization and the unique accounting principles. The accounting aspects of profit and loss agreements, changes in the composition of partners (admissions and withdrawals), and partnership liquidations are fully illustrated. The end-of-chapter material in this area focuses on evaluating various alternative strategies available to partners, for example, deciding whether it would be better to liquidate a partnership or admit a new partner.

Governmental and Not-for-Profit Accounting (Chapters 15–19)

Chapters 15–19 provide comprehensive coverage of accounting and financial reporting of state and local governments, colleges and universities, health care entities, and not-for-profit organizations. Since the eleventh edition of this text was released, standards-setting bodies have issued several accounting, auditing, and financial reporting standards that impact topics covered in these chapters. This edition discusses recent developments in state and local government accounting and financial reporting.

Chapter 15 covers the unique accounting and financial reporting issues of state and local governments. It describes the basics of accounting and financial reporting of the general fund and account groups. The chapter incorporates GASB guidance on accounting for revenues and expenditures using a financial resources measurement focus and a modified accrual basis of accounting. The unique ways of accounting for capital assets and long-term debt are detailed.

Chapter 16 details accounting for the specialized funds of government, e.g., those established to account for restricted operating resources, long-term construction projects or acquisition of major fixed assets, and servicing of principal and interest on long-term debt. The chapter also covers the unique accounting for various trust funds, including permanent funds and proprietary (business-type) funds. Illustrated examples include accounting for pensions, postretirement benefits other than pensions, recognition of assets and liabilities and related disclosures arising from securities lending transactions, accounting for certain investments at fair value, and accounting for landfill operations.

Chapter 17 presents the required governmental basic financial statements. The unique features of the *funds-based statements*, which maintain the traditional measurement focus and basis of accounting for both governmental and proprietary funds, and the *government-wide statements*, which use the flow of economic resources measurement focus and full accrual basis of accounting for both the government and proprietary activities, are detailed. The chapter includes a discussion of the requirement for governments to report all capital assets, including reporting of infrastructure assets. Detailed illustrations help to clarify the requirements to report depreciation or use the modified approach. The chapter contains a sample government-wide statement of net assets that reports governmental and proprietary activities in separate columns and a program- or function-oriented statement of activities. The requirements for the *management's discussion and analysis* (MD&A) are highlighted. End-of-chapter problems are designed to link theory to practice through the use of electronic working papers and supporting schedules. Additional coverage surrounds key issues in governmental audit, including the single audit requirements, from AICPA, OMB, and GAO authoritative sources.

Chapter 18 begins with an overall summary of the accounting and financial reporting standards as they apply to all not-for-profit organizations. Coverage of ASC 958 is included. Expanded illustrations enable the student to better grasp the unique requirements for revenue and expense recognition of not-for-profit organizations. External financial statements are illustrated without a funds structure. Since the FASB standards have shifted financial reporting away from fund accounting, funds are viewed as internal control and management tools throughout this chapter. The appendix to the chapter includes a discussion of the fund structure traditionally used in not-for-profit organizations and illustrates financial statements incorporating the funds.

Chapter 19 offers a complete description of accounting for private and governmental universities and private and governmental health care organizations. The concepts from Chapters 15–18 are applied to college and university accounting. A comparison of the governmental and nongovernmental reporting requirements and/or practices is highlighted to enable the student to gain a better understanding of differences between them. Updated illustrations and end-of-chapter materials are also designed to compare and contrast the government and private-sector requirements.

Fiduciary Accounting (Chapters 20 and 21)

The role of estate planning and the use of trusts are important to many individuals and present some unique accounting principles. The tax implications of estate planning are discussed so that the student has a basic understanding of this area. Various accounting reports necessary for the administration of an estate or trust are illustrated in Chapter 20. Current estate tax rates and unified credit amounts are set forth in the chapter.

No business is immune from financial difficulty. Chapter 21 discusses various responses to such difficulties, including troubled debt restructuring, quasi-reorganizations, corporate liquidations, and corporate reorganizations.

UNPARALLELED SUPPORT

Supplementary Materials for the Instructor

Solutions Manual. This manual provides answers to all end-of-chapter "Understanding the Issues" questions and solutions to all exercises, problems, and cases. The electronic files for this ancillary can be found on the Instructor's Resource CD and in the Instructor Resources section of the text's Web site (www.cengagebrain.com).

Test Bank. Consisting of a variety of multiple-choice questions and short problems and the related solutions, this test bank had been updated. The content includes testing questions for the text chapters and the derivatives module.

PowerPoint® Slides. Instructor PowerPoint presentations are available in electronic format.

Instructor Web Site (www.cengagebrain.com). All supplemental materials are available online at www.cengagebrain.com.

Valuable Supplementary Material for the Student

Excel® Tutorial and Working Papers. Provided on the text's Web site (www.cengagebrain.com), this step-by-step tutorial carefully guides students as they learn how to set up worksheets in Excel and apply their consolidations knowledge learned in Chapters 1–6 of the text.

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Brief Contents

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PART

1 Combined Corporate Entities and Consolidations

The acquisition of one company by another is a commonplace business activity. Frequently, a company is groomed for sale. Also, the recent proliferation of new technology businesses and financial services firms that merge into larger companies is an expected, and often planned for, occurrence. For three decades, prior to 2001, accounting standards for business combinations had remained stable. Two models of recording combinations had coexisted. The pooling-of-interests method brought over the assets and liabilities of the acquired company at existing book values. The purchase method brought the acquired company's assets and liabilities to the acquiring firm's books at fair market value. FASB Statement No. 141, issued in July 2001, ended the use of the pooling method and gave new guidance for recording business combinations under purchase accounting principles.

Two new FASB Statements issued in 2007 brought major changes to accounting for business combinations. FASB Statement 14lr required that all accounts of an acquired company be recorded at fair value, no matter the percentage of interest acquired or the price paid. FASB Statement 160 required new rules for accounting for the interest not acquired by the acquiring firm. This interest is known as the noncontrolling interest. It is now recorded at fair value on the acquisition date and is considered a part of the stockholder's equity of the consolidated firm.

The contents of FASB Statements 14lr and 160 are now incorporated into FASB ASC 805 and 810, respectively. ASC stands for Accounting Standards Codification. These statements are unique in that they were produced in a joint effort with the International Accounting Standards Board (IASB). Some minor differences still exist between U.S. GAAP and international rules. They are described in Chapter 2. Throughout this book, a new feature called "IASB Perspectives" will address the ever-changing relationship between U.S. GAAP and International Financial Reporting Standards (IFRS).This feature is not found in all chapters, but has been included where applicable.

There are two types of accounting transactions to accomplish a combination. The first is to acquire the assets and liabilities of a company directly from the company itself by paying cash or by issuing bonds or stock. This is called a *direct asset acquisition* and is studied in Chapter 1. The assets and liabilities of the new company are directly recorded on the parent company's books. All of the theory involving acquisitions is first explained in this context.

The more common way to achieve control is to acquire a controlling interest, usually over 50%, in the voting common stock of another company. The acquiring company simply records an investment account for its interest in the new company. Both companies maintain their own accounting records. However, when two companies are under common control, a single set of *consolidated statements* must be prepared to meet external reporting requirements. The investment account is eliminated and the individual assets and liabilities of the acquired company are merged with those of the parent company. Chapters 2 through 8 provide the methods for consolidating the separate statements of the affiliated firms into a consolidated set of financial statements. The consolidation process becomes a continuous activity, which is further complicated by continuing transactions between the affiliated companies.

Business Combinations: New Rules for a Long-Standing Business Practice

CHAPTER 1

Learning Objectives

When you have completed this chapter, you should be able to

1. **Describe the major economic advantages of business combinations.**
2. **Differentiate between accounting for an acquisition of assets and accounting for an acquisition of a controlling interest in the common stock of a company.**
3. **Explain the basics of the acquisition model.**
4. **Allocate the acquisition price to the assets and liabilities of the acquired company.**
5. **Demonstrate an understanding of the tax issues that arise in an acquisition.**
6. **Explain the disclosure that is required in the period in which an acquisition occurs.**
7. **Apply the impairment test to goodwill and adjust goodwill when needed.**
8. **Estimate the value of goodwill. (Appendix)**

Business combinations have been a common business transaction since the start of commercial activity. The concept is simple: A business combination is the acquisition of all of a company's assets at a single price. *Business combinations* is a comprehensive term covering all acquisitions of one firm by another. Such combinations can be further categorized as either mergers or consolidations. The term *merger* applies when an existing company acquires another company and combines that company's operations with its own. The term *consolidation* applies when two or more previously separate firms join and become one new, continuing company. Business combinations make headlines not only in the business press but also in the local newspapers of the communities where the participating companies are located. While investors may delight in the price received for their interest, employees become concerned about continued employment, and local citizens worry about a possible relocation of the business.

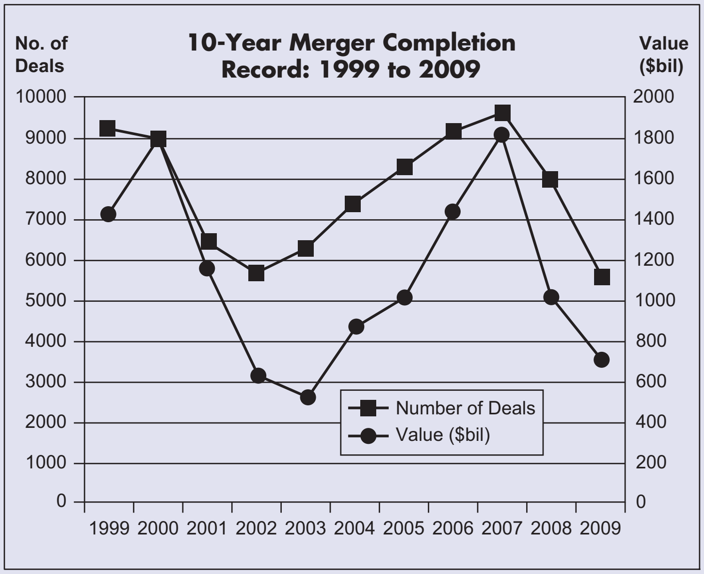
The popularity of business combinations grew steadily during the 1990s and peaked in 1998. From then until 2003, activity slowed considerably, with the dollar amount of deals falling even more than the number of deals. From 2003 to 2007, there was a steady rise in deals and the dollar amount of acquisitions. By 2009, the number of deals and their value fell to roughly half of their 2007 levels. Exhibit 1-1 includes the Merger Completion Record covering 1999 through 2009. The data include all acquisitions in which a U.S. company was involved as either a buyer or seller. The drastic change in business combinations can be attributed to several possible causes, such as the following:

- The growth period prior to 2002 reflects, in part, the boom economy of that period, especially in high-tech industries. There was also a motivation to complete acquisitions prior to July 1, 2001, when FASB Statement No. 141, *Business Combinations,* became effective. FASB Statement No. 141 eliminated the pooling-of-interests method. Pooling allowed companies to record the acquired assets at existing book value. This meant less depreciation and amortization charges in later periods. When the alternative purchase method was used prior to 2001, any goodwill that was recorded could be amortized over 40 years. After 2001,

Exhibit 1-1
10-Year Merger Completion Record: 1999–2009

10-Year Merger Completion Record: 1999 to 2009

Year	No. of Deals	% Change	Value ($bil)	% Change
1999	9,248	—	1,423.1	—
2000	8,974	–3.0	1,786.3	25.5
2001	6,423	28.4	1,155.4	–35.3
2002	5,685	–11.5	626.7	–45.8
2003	6,269	10.3	526.9	15.9
2004	7,350	17.2	866.4	64.4
2005	8,249	12.2	1,012.2	16.8
2006	9,141	10.8	1,431.3	41.4
2007	9,575	4.7	1,808.1	26.3
2008	7,917	–17.3	999.2	–44.7
2009	5,514	–30.4	703.1	–29.6



Source: Mergers and Acquisitions Almanac, February 2010, p. 31.

FASB Statement No. 141 required goodwill impairment testing, which meant there was a risk of a major goodwill impairment loss in a future period.

- The decline in acquisition activity could also be attributed to the soft economy during the post-2001 period. The high-tech sector of the economy, which had been a hotbed of combinations, was especially weak. Add to it the increased scrutiny of companies being acquired, as caused by the accounting and business scandals of the period, and the motivation to acquire was lessened.
- Aside from broad-based accounting infractions, specific allegations of precombination beautification arose. It became clear that adjustments were made to the books of the company being acquired to make it look more valuable as a takeover candidate. This included arranging in advance to meet the pooling-of-interests criteria and making substantial write-offs to enhance post-acquisition income. In the fall of 1999, it was alleged that Tyco International arranged to have targeted companies take major write-downs before being acquired by Tyco. This concern caused a major decline in the value of Tyco shares and led to stockholder suits against the company.
- The steady increase in acquisition activity after 2002 could be attributed to a growing economy and stabilization in the accounting method used.
- The steep decline in activity since 2007 is likely a result of the deep recession during that time period. With improvements in the economy during 2010, business acquisitions have accelerated.
- Acquisitions per year have been fairly level since 2010. For an updated count of activity, do a computer Internet search using "Thomson-Reuters Mergers and Acquisitions Review" and select the latest quarterly report.

1
OBJECTIVE

Describe the major economic advantages of business combinations.

ECONOMIC ADVANTAGES OF COMBINATIONS

Business combinations are typically viewed as a way to jump-start economies of scale. Savings may result from the elimination of duplicative assets. Perhaps both companies will utilize common facilities and share fixed costs. There may be further economies as one management team replaces two separate sets of managers. It may be possible to better coordinate production, marketing, and administrative actions. The U.S. Federal Trade Commission defines six types of mergers. They are:

Backward Vertical Integration. This is a deal where a company moves down the production–marketing cycle by acquiring a supplier of products or services it provides.

Example: The acquisition of Smith International by Slumberger. Smith International is a provider of drilling bits and fluids to the oil industry. Slumberger is an oil field service company providing a range of services to oil companies including drilling of oil wells. The transaction was stock for stock and will likely be a tax-free exchange for investors (to be explained in a following section).

Forward Vertical Integration. This is a merger where a company moves up the production–marketing cycle by acquiring a company that uses its products.

Example: The acquisition of Healthvision Solutions, Inc., by Lawson Software. Lawson is a provider of software solutions including healthcare applications. Healthvision provides integrated healthcare technologies directly to healthcare organizations. This was an acquisition for cash.

Horizontal Merger. This is a merger of companies that offer similar products or services and are likely competitors in the same market space.

Example: The huge drug store chain, Walgreen Company, acquired the New-York-based drug store chain of Duane Reade Holdings, Inc. This cash acquisition quadrupled the number of stores Walgreen has in the metro New York area.

Product Extension Merger. This is a merger where the acquiring company is expanding its product offerings in the marketplace in which it already sells products and/or services.

Example: R. R. Donnelley & Sons Company acquired, for cash, Browne & Company. Donnelley provides integrated communication services for a wide range of customers. Browne provides critical capital markets communications.

Market Extension Merger. This merger increases the geographic market coverage of the same products or services already offered by the acquiring company.

Example: First Energy acquired Allegheny Energy. Both companies are power companies. The acquisition expands First Energy's market in Pennsylvania and extends its market to include portions of West Virginia, Maryland, and Virginia.

Conglomerate Merger. Example: This is an acquisition of a firm in an unrelated line of business. In effect, the acquiring firm has a portfolio of investments. Some have said that a conglomerate is similar to a mutual fund in its purpose to maximize returns over a range of companies.

Thomas H. Lee Partners acquired for cash CKE Restaurants, Inc. CKE owns the Carl's Jr. and Hardee's quick service restaurant chains. Thomas H. Lee Partners businesses include information services, lending, publishing, music, and consumer products, including Snapple.

Tax Advantages of Combinations

Perhaps the most universal economic benefit in business combinations is a possible tax advantage. The owners of a business, whether sole proprietors, partners, or shareholders, may wish to retire from active management of the company. If they were to sell their interest for cash or accept debt instruments, they would have an immediate taxable gain. If, however, they accept the common stock of another corporation in exchange for their interest and carefully craft the transaction as a "tax-free reorganization," they may account for the transaction as a tax-free exchange. No taxes are paid until the shareholders sell the shares received in the business combination. The shareholder records the new shares received (for tax purposes) at the book value of the exchanged shares.

In early 2014, Iberiabank Corporation filed a form 8K with the SEC which provided the following information concerning its merger with Teche Holding Company:

> *On January 12, 2014, IBERIABANK Corporation ("IBKC") the parent company of IBERIABANK, entered into an Agreement and Plan of Merger (the "Merger Agreement") with Teche Holding Company ("TSH"), the parent company of Teche Federal Bank. Under the Merger Agreement, TSH will merge into the IBKC (the "Merger") after which Teche Federal Bank will merge with and into IBERIABANK. Each outstanding share of TSH's common stock will be converted into the right to receive 1.162 shares of IBKC common stock at the effective time of the Merger (the "Exchange Ratio") plus cash in lieu of any fractional interest. The Exchange Ratio will be adjusted if the market price of IBKC common stock on the NASDAQ*

Global Select Market during the prescribed measurement period to the merger falls below $55.80 or rises above $68.20, pursuant to the formula set forth in the Merger Agreement. All TSH stock options, whether or not vested, will be cashed out and shares of restricted stock will become fully vested in connection with the transaction and will be exchanged for shares of IBKC common stock like the other shares of TSH common stock.

The Merger is intended to qualify as a tax-free reorganization for federal income tax purposes. The Merger is expected to close during the second quarter of 2014. If the Merger is not consummated under certain circumstances, TSH has agreed to pay IBKC a termination fee up to $5,000,000, and IBKC has agreed to pay TSH a termination fee of up to $4,000,000 in certain circumstances.[1]

Further tax advantages exist when the target company has reported losses on its tax returns in prior periods. Section 172 of the Internal Revenue Code provides that operating losses can generally be carried back two years to obtain a refund of taxes paid in previous years. In an effort to stimulate the economy, Congress enacted a special 5-year carryback for 2008 and 2009 operating losses. Should the loss not be offset by income in the allowed prior years, the loss may be carried forward up to 20 years to offset future taxable income, thus eliminating or reducing income taxes that would otherwise be payable. These loss maneuvers have little or no value to a target company that has not had income in the two prior years and does not expect profitable operations in the near future. However, tax losses are transferable in a business combination. To an acquiring company that has a profit in the current year and/or expects profitable periods in the future, the tax losses of a target company may have real value. That value, viewed as an asset by the acquiring company, will be reflected in the price paid. However, the acquiring company must exercise caution in anticipating the benefits of tax loss carryovers. The realization of the tax benefits may be denied if it can be shown that the primary motivation for the combination was the transfer of the tax loss benefit.

A tax benefit may also be available in a subsequent period as a consolidated tax return is filed by the single remaining corporation. The losses of one of the affiliated companies can be used to offset the net income of another affiliated company to lessen the taxes that would otherwise be paid by the profitable company.

REFLECTION

- Business combinations may have a wide range of economic advantages to a firm including vertical and horizontal integration, market and product expansion and diversification as a conglomerate company.
- Potential sellers may be motivated by the tax advantages available to them in a business combination.

2
OBJECTIVE

Differentiate between accounting for an acquisition of assets and accounting for an acquisition of a controlling interest in the common stock of a company.

ACQUISITION OF CONTROL

Control of another company may be achieved by either acquiring the assets of the target company or acquiring a controlling interest (typically over 50%) in the target company's voting common stock. In an *acquisition of assets,* all of the company's assets are acquired *directly* from the company. In most cases, existing liabilities of the acquired company also are assumed. When assets are acquired and liabilities are assumed, we refer to the transaction as an acquisition of "net assets." Payment could be made in cash, exchanged property, or issuance of either debt or equity securities. It is common to issue securities since this avoids depleting cash or other assets that may be needed in future operations. Legally, a *statutory consolidation* refers to the

1 Iberiabank Corp (IBKC) form 8-K filed with SEC on January 13, 2014.

combining of two or more previously independent legal entities into one new legal entity. The previous companies are dissolved and are then replaced by a single continuing company. A *statutory merger* refers to the absorption of one or more former legal entities by another company that continues as the sole surviving legal entity. The absorbed company ceases to exist as a legal entity but may continue as a division of the surviving company.

In a *stock acquisition,* a controlling interest (typically, more than 50%) of another company's voting common stock is acquired. The company making the acquisition is termed the *parent* (also the acquirer), and the company acquired is termed a *subsidiary* (also the acquiree). Both the parent and the subsidiary remain separate legal entities and maintain their own financial records and statements. However, for external financial reporting purposes, the companies usually will combine their individual financial statements into a single set of consolidated statements. Thus, the term "consolidation" may refer to a statutory combination or, more commonly, to the consolidated statements of a parent and its subsidiary.

There may be several advantages to obtaining control by acquiring a controlling interest in stock. The most obvious one is that the total cost is lower, since only a controlling interest in the assets, and not the total assets, must be acquired. In addition, control through stock ownership may be simpler to achieve since no formal negotiations or transactions with the acquiree's management are necessary. Further advantages may result from maintaining the separate legal identity of the acquiree company. First of all, risk is lowered because the legal liability of each corporation is limited to its own assets. Secondly, separate legal entities may be desirable when only one of the companies, such as a utility company, is subject to government control. Lastly, tax advantages may result from the preservation of the legal entities.

Stock acquisitions are said to be "friendly" when the stockholders of the acquiree corporation, as a group, decide to sell or exchange their shares. In such a case, an offer may be made to the board of directors by the acquiring company. If the directors approve, they will recommend acceptance of the offer to the shareholders, who are likely to approve the transaction. Often, a two-thirds vote is required. Once approval is gained, the exchange of shares will be made with the individual shareholders. If the officers decline the offer, or if no offer is made, the acquirer may deal directly with individual shareholders in an attempt to secure a controlling interest. Frequently, the acquirer may make a formal *tender offer.* The tender offer typically will be published in newspapers and will offer a greater-than-market price for shares made available by a stated date. The acquirer may reserve the right to withdraw the offer if an insufficient number of shares is made available to it. Where management and/or a significant number of shareholders oppose the acquisition of the company by the intended buyer, the acquisition is viewed as hostile. Unfriendly offers are so common that several standard defensive mechanisms have evolved. Following are the common terms used to describe these defensive moves.

Greenmail. The target company may pay a premium price ("greenmail") to buy back its own shares. It may either buy shares already owned by a potential acquiring company or purchase shares from a current owner who, it is feared, would sell to the acquiring company. The price paid for these shares in excess of their market price may not be deducted from stockholders' equity; instead, it is expensed.[2]

White Knight. The target company locates a different company to acquire a controlling interest. This could occur when the original acquiring company is in a similar industry and it is feared that current management of the target company would be displaced. The replacement acquiring company, the "white knight," might be in a different industry and could be expected to keep current management intact.

Poison Pill. The "poison pill" involves the issuance of stock rights to existing shareholders to purchase additional shares at a price far below fair value. However, the rights are exercisable only when an acquiring company purchases or makes a bid to purchase a stated number of shares. The effect of the options is to substantially raise the cost to the acquiring company. If the attempt fails, there is at least a greater gain for the original shareholders.

2 FASB ASC 505-30-25-4, *Equity-Treasury Stock—Recognition* (Norwalk, CT , 2010).

Selling the Crown Jewels. This approach has the management of the target company selling vital assets (the "crown jewels") of the target company to others to make the company less attractive to the acquiring company.

Leveraged Buyouts. The management of the existing target company attempts to purchase a controlling interest in that company. Often, substantial debt will be incurred to raise the funds needed to purchase the stock; hence the term "leveraged buyout." When bonds are sold to provide this financing, the bonds may be referred to as "junk bonds," since they are often high-interest and high-risk due to the high debt-to-equity ratio of the resulting corporation.

Further protection against takeovers is offered by federal and state law. The Clayton Act of 1914 (Section 7) is a federal law that prohibits business combinations in which "the effect of such acquisition may be substantially to lessen competition or to tend to create a monopoly."

The Williams Act of 1968 is a federal law that regulates tender offers; it is enforced by the Securities and Exchange Commission (SEC). Several states also have enacted laws to discourage hostile takeovers. These laws are motivated, in part, by the fear of losing employment and taxes.

Accounting Ramifications of Control

When control is achieved through an asset acquisition, the acquiring company records on its books the assets and assumed liabilities of the acquired company. From the acquisition date on, all transactions of both the acquiring and acquired company are recorded in one combined set of accounts. The only new skill one needs to master is the proper recording of the acquisition when it occurs. **Once the initial acquisition is properly recorded, subsequent accounting procedures are the same as for any single accounting entity.** Combined statements of the new, larger company for periods following the combination are automatic.

Accounting procedures are more involved when control is achieved through a stock acquisition. The controlling company, the parent, will record only an investment account to reflect its interest in the controlled company, the subsidiary. Both the parent and the subsidiary remain separate legal entities with their own separate sets of accounts and separate financial statements. Accounting theory holds that where one company has effective control over another, there is only one economic entity and there should be only one set of financial statements that combines the activities of the entities under common control. The accountant will prepare a worksheet, referred to as the *consolidated worksheet,* that starts with the separate accounts of the parent and the subsidiary. Various adjustments and eliminations will be made on this worksheet to merge the separate accounts of the two companies into a single set of financial statements, which are called *consolidated statements.*

This chapter discusses business combinations resulting from asset acquisitions, since the accounting principles are more easily understood in this context. The principles developed are applied directly to stock acquisitions that are presented in the chapters that follow.

R E F L E C T I O N

- Control of another company is gained by either acquiring all of that firm's assets (and usually its liabilities) or by acquiring a controlling interest in that company's voting common stock.
- Control through an acquisition of assets requires the correct initial recording of the purchase. Combined statements for future periods are automatically produced.

3

OBJECTIVE

Explain the basics of the acquisition model.

EVOLUTION OF ACCOUNTING METHODS

Prior to the issuance of FASB Statement No. 141 in 2001, two methods were used to account for business combinations. These were the purchase method and the pooling-of-interests method. The *purchase method* usually recorded all assets and liabilities of the company acquired at fair value. The purchase method was the primary method in use. However, under some circumstances, the pooling-of-interests method was allowed. The *pooling-of-interests method* recorded the assets and liabilities of the acquired firm at their existing book values. This method was intended to be applied to business combinations that were a "merger of equals." Specific criteria existed as to combinations that would qualify. Ninety percent of the stock of the firm acquired had to be received in exchange for the shares of the acquiring firm. All shareholders of the acquired firm had to be treated equally. Numerous other criteria also attempted to guarantee a fusion of existing owners rather than a takeover of one company by another. In the end, some companies engaged in a series of equity transactions prior to the combination so that they would be able to meet the pooling criteria. Pooling allowed the carry over of book values to the acquiring firm. That resulted in greater future income because of typically lower depreciation and amortization charges on assets. Pooling did not result in new goodwill being recorded. At that time goodwill was amortized. Thus, pooling also led to greater income in the future since there would be no goodwill amortization.

FASB Statement No. 141 eliminated the pooling method. Assets and liabilities acquired in a pooling of interests, that began prior to the effective date of FASB Statement No. 141, were allowed to continue as originally recorded. This means that current-era financial statements still include assets and liabilities of a firm acquired in a pooling that were initially recorded at their book values on the acquisition date.

The purchase method required under FASB Statement No. 141 focused only on recording fair values for the portion of the assets and liabilities acquired in the purchase. The accounts of the acquired company would only be adjusted to full fair value if the parent company acquired a 100% interest in the acquired firm. If, for example, the purchasing company bought only an 80% interest in the acquired firm, accounts would be adjusted by only 80% of the difference between book and fair value. Thus, in an 80% purchase, an asset with a book value of $6,000 and a fair value of $10,000 would be recorded at $9,200 ($6,000 book value plus 80% × $4,000 excess of fair value over book value).

The new *acquisition method* included in FASB Statement No. 14lr (now included in FASB ASC 805), issued in 2007, requires that all assets and liabilities be recorded at fair value regardless of the percentage interest purchased by the acquiring company (provided that the interest purchased is large enough to constitute a controlling interest). In the above example, the asset illustrated would be recorded at the full $10,000 fair value even though the acquiring company only purchased an 80% interest in the company that owns the asset. The acquisition method also eliminated the prior practice of discounting of fixed and intangible assets to a value less than fair value. This would happen under the purchase method when, in a rare case, the acquiring firm made a "bargain purchase." A *bargain purchase* occurs when the price paid for a company is less than the sum of the fair value of its net assets (sum of all assets minus all liabilities).

Applying the Acquisition Method

The four steps in the acquisition method are as follows:

1. Identify the acquirer.
2. Determine the acquisition date.
3. Measure the fair value of the acquiree (the company being acquired).
4. Record the acquiree's assets and liabilities that are assumed.

Identify the Acquirer. In an asset acquisition, the company transferring cash or other assets and/or assuming liabilities is the acquiring company. In a stock acquisition, the acquirer is, in most cases, the company transferring cash or other assets for a controlling interest in the voting common stock of the acquiree (company being acquired). Some stock acquisitions may be accomplished by exchanging voting common stock. Most often, the company issuing the voting common stock is the acquirer. In some cases, the acquiree may issue the stock in the acquisition. This "reverse acquisition" may occur when a publicly traded company is acquired by a privately traded company. The appendix at the end of Chapter 2 considers this situation and provides the applicable accounting methods.