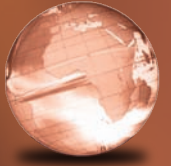


GLOBAL
EDITION



Advanced Accounting

TWELFTH EDITION

Floyd A. Beams • Joseph H. Anthony
Bruce Bettinghaus • Kenneth A. Smith

ALWAYS LEARNING

PEARSON

ADVANCED ACCOUNTING

12TH EDITION

ADVANCED ACCOUNTING

GLOBAL EDITION

Floyd A. Beams

Virginia Polytechnic Institute
and State University

Joseph H. Anthony

Michigan State University

Bruce Bettinghaus

Grand Valley State University

Kenneth A. Smith

University of Washington

PEARSON

Boston Columbus Indianapolis New York San Francisco Upper Saddle River
Amsterdam Cape Town Dubai London Madrid Milan Munich Paris Montréal Toronto
Delhi Mexico City São Paulo Sydney Hong Kong Seoul Singapore Taipei Tokyo

Vice President, Product Management: Donna Battista
Director of Editorial Services: Ashley Santora
Head of Learning Asset Acquisition, Global Editions: Laura Dent
Sponsoring Editor: Nicole Sam
Acquisitions Editor, Global Editions: Debapriya Mukherjee
Editorial Project Manager: Heather McNally
Editorial Assistant: Christine Mallon
Assistant Project Editor, Global Editions: Paromita Banerjee
Vice President, Marketing: Maggie Moylan
Director, Strategy and Marketing: Scott Dustan
Manager, Field Marketing: Leigh Ann Sims
Product Marketing Manager: Alison Haskins
Executive Field Marketing Manager: Lori DeShazo
Senior Strategic Marketing Manager: Erin Gardner
Senior Production Manufacturing Controller, Global Editions: Trudy Kimber
Managing Editor: Jeff Holcomb
Senior Production Project Manager: Meredith Gertz
Senior Manufacturing Buyer: Carol Melville
Cover Designer: Joyce Wells
Cover Image: © Axel Lauer/Shutterstock
Full-Service Project Management, Composition, Text Illustrations, and Text Design: Lumina Datamatics, Inc.

Credits and acknowledgments borrowed from other sources and reproduced, with permission, in this textbook appear on appropriate page within text.

Pearson Education Limited
Edinburgh Gate
Harlow
Essex CM20 2JE
England and Associated Companies throughout the world

Visit us on the World Wide Web at:
www.pearsonglobaleditions.com

© Pearson Education Limited 2015

The rights of Floyd A. Beams, Joseph H. Anthony, Bruce Bettinghaus, and Kenneth A. Smith to be identified as authors of this work have been asserted by them in accordance with the Copyright, Designs and Patents Act 1988.

Authorized adaptation from the United States edition, entitled Advanced Accounting, 12th Edition, ISBN 978-0-13-34-5186-3 by Floyd A. Beams, Joseph H. Anthony, Bruce Bettinghaus, and Kenneth A. Smith, published by Pearson Education © 2015.

All rights reserved. No part of this publication may be reproduced, stored in a retrieval system, or transmitted in any form or by any means, electronic, mechanical, photocopying, recording or otherwise, without either the prior written permission of the publisher or a license permitting restricted copying in the United Kingdom issued by the Copyright Licensing Agency Ltd, Saffron House, 6–10 Kirby Street, London EC1N 8TS.

All trademarks used herein are the property of their respective owners. The use of any trademark in this text does not vest in the author or publisher any trademark ownership rights in such trademarks, nor does the use of such trademarks imply any affiliation with or endorsement of this book by such owners.

British Library Cataloguing-in-Publication Data

A catalogue record for this book is available from the British Library

10 9 8 7 6 5 4 3 2 1 15 14 13 12 11
ISBN-13: 978-1-292-05934-1
ISBN-10: 1-292-05934-6

Typeset in 10/12 Times LT Std by Lumina Datamatics, Inc.
Printed and bound by Courier Kendallville in United States of America

To Beth

JOE ANTHONY

To Trish

BRUCE BETTINGHAUS

To Karen, Madelyn and AJ

KENNETH A. SMITH

ABOUT THE AUTHORS

FLOYD A. BEAMS, PH.D., authored the first edition of *Advanced Accounting* in 1979 and actively revised his text through the next six revisions and twenty-one years while maintaining an active professional and academic career at Virginia Tech where he rose to the rank of Professor, retiring in 1995.

Beams earned his B.S. and M.A. degrees from the University of Nebraska, and a Ph.D. from the University of Illinois. He published actively in journals, including *The Accounting Review*, *Journal of Accounting, Auditing and Finance*, *Journal of Accountancy*, *The Atlantic Economic Review*, *Management Accounting*, and others. He was a member of the American Accounting Association and the Institute of Management Accountants and served on committees for both organizations. Beams was honored with the National Association of Accountants' Lybrand Bronze Medal Award for outstanding contribution to accounting literature, the Distinguished Career in Accounting award from the Virginia Society of CPAs, and the Virginia Outstanding Accounting Educator award from the Carman G. Blough student chapter of the Institute of Management Accountants. Professor Beams passed away in 2004; however, we continue to honor his contribution to the field and salute the impact he had on this volume.

JOSEPH H. ANTHONY, PH.D., joined the Michigan State University faculty in 1983 and is an Associate Professor of Accounting at the Eli Broad College of Business. He earned his B.A. in 1971 and his M.S. in 1974, both awarded by Pennsylvania State University, and he earned his Ph.D. from The Ohio State University in 1984. He is a Certified Public Accountant, and is a member of the American Accounting Association, American Institute of Certified Public Accountants, American Finance Association, and Canadian Academic Accounting Association. He has been recognized as a Lilly Foundation Faculty Teaching Fellow and as the MSU Accounting Department's Outstanding Teacher in 1998–1999 and in 2010–2011.

Anthony teaches a variety of courses, including undergraduate introductory, intermediate, and advanced financial accounting. He also teaches financial accounting theory and financial statement analysis at the master's level, as well as financial accounting courses in Executive MBA programs, and a doctoral seminar in financial accounting and capital markets research. He co-authored an introductory financial accounting textbook.

Anthony's research interests include financial statement analysis, corporate reporting, and the impact of accounting

information in the securities markets. He has published a number of articles in leading accounting and finance journals, including *The Journal of Accounting & Economics*, *The Journal of Finance*, *Contemporary Accounting Research*, *The Journal of Accounting, Auditing, & Finance*, and *Accounting Horizons*.

BRUCE BETTINGHAUS, PH.D., is an Assistant Professor of Accounting in the School of Accounting in The Seidman College of Business at Grand Valley State University. His teaching experience includes corporate governance and accounting ethics, as well as accounting theory and financial reporting for both undergraduates and graduate classes. He earned his Ph.D. at Penn State University and his B.B.A. at Grand Valley State University. Bruce has also served on the faculties of the University of Missouri and Michigan State University. He has been recognized for high-quality teaching at both Penn State and Michigan State Universities. His research interests focus on governance and financial reporting for public firms. He has published articles in *The International Journal of Accounting* and *The Journal of Corporate Accounting and Finance*.

KENNETH A. SMITH, PH.D., is a senior lecturer in the Evans School of Public Affairs at the University of Washington. He earned his Ph.D. from the University of Missouri, his M.B.A. from Ball State University, and his B.A. in Accounting from Anderson University (IN). He is a Certified Public Accountant. Smith's research interests include government accounting and budgeting, non-profit financial management, non-financial performance reporting, and information systems in government and non-profit organizations. He has published articles in such journals as *Accounting Horizons*, *Journal of Government Financial Management*, *Public Performance & Management Review*, *Nonprofit and Voluntary Sector Quarterly*, *International Public Management Journal*, *Government Finance Review*, and *Strategic Finance*.

Smith's professional activities include membership in the American Accounting Association, the Association of Government Accountants, the Government Finance Officers Association, the Institute of Internal Auditors, and the Institute of Management Accountants. He serves on the Steering Committee for the Public Performance Measurement Reporting Network and formerly served as the Executive Director for the Oregon Public Performance Measurement Association.

BRIEF CONTENTS

Preface 17

CHAPTER 1

Business Combinations 25

CHAPTER 2

Stock Investments—Investor Accounting and Reporting 49

CHAPTER 3

An Introduction to Consolidated Financial Statements 85

CHAPTER 4

Consolidation Techniques and Procedures 121

CHAPTER 5

Intercompany Profit Transactions—Inventories 167

CHAPTER 6

Intercompany Profit Transactions—Plant Assets 207

CHAPTER 7

Intercompany Profit Transactions—Bonds 239

CHAPTER 8

Consolidations—Changes in Ownership Interests 267

CHAPTER 9

Indirect and Mutual Holdings 297

CHAPTER 10

Subsidiary Preferred Stock, Consolidated Earnings per Share, and Consolidated Income Taxation 331

CHAPTER 11

Consolidation Theories, Push-Down Accounting, and Corporate Joint Ventures 381

CHAPTER 12

Derivatives and Foreign Currency: Concepts and Common Transactions 421

CHAPTER 13

Accounting for Derivatives and Hedging Activities 439

CHAPTER 14

Foreign Currency Financial Statements 473

CHAPTER 15

Segment and Interim Financial Reporting 507

CHAPTER 16

Partnerships—Formation, Operations, and Changes in Ownership Interests 533

CHAPTER 17

Partnership Liquidation 569

CHAPTER 18

Corporate Liquidations and Reorganizations 599

CHAPTER 19

An Introduction to Accounting for State and Local Governmental Units 633

CHAPTER 20

Accounting for State and Local Governmental Units—Governmental Funds 671

CHAPTER 21

Accounting for State and Local Governmental Units—Proprietary and Fiduciary Funds 719

CHAPTER 22

Accounting for Not-for-Profit Organizations 745

CHAPTER 23

Estates and Trusts 781

Glossary G-1

Index I-1

CONTENTS

Preface 17

CHAPTER 1

Business Combinations 25

- Reasons for Business Combinations 26
- Antitrust Considerations 27
- Legal Form of Business Combinations 28
- Accounting Concept of Business Combinations 29
- Accounting for Combinations as Acquisitions 30
- Disclosure Requirements 39
- The Sarbanes-Oxley Act 39

CHAPTER 2

Stock Investments—Investor Accounting and Reporting 49

- Accounting for Stock Investments 49
- Equity Method—a One-Line Consolidation 52
- Investment in a Step-by-Step Acquisition 60
- Sale of an Equity Interest 61
- Stock Purchases Directly from the Investee 61
- Investee Corporation with Preferred Stock 62
- Extraordinary Items and other Considerations 63
- Disclosures for Equity Investees 63
- Testing Goodwill for Impairment 65

CHAPTER 3

An Introduction to Consolidated Financial Statements 85

- Business Combinations Consummated through Stock Acquisitions 85
- Consolidated Balance Sheet at Date of Acquisition 89
- Consolidated Balance Sheets after Acquisition 93
- Assigning Excess to Identifiable Net Assets and Goodwill 95
- Consolidated Income Statement 101
- Push-Down Accounting 102
- Preparing a Consolidated Balance Sheet Worksheet 103

CHAPTER 4**Consolidation Techniques and Procedures 121**

Consolidation under the Equity Method 121

Locating Errors 128

Excess Assigned to Identifiable Net Assets 128

Consolidated Statement of Cash Flows 134

Preparing a Consolidation Worksheet 139

CHAPTER 5**Intercompany Profit Transactions—Inventories 167**

Intercompany Inventory Transactions 168

Downstream and Upstream Sales 172

Unrealized Profits from Downstream Sales 175

Unrealized Profits from Upstream Sales 178

Consolidation Example—Intercompany Profits from Downstream Sales 180

Consolidation Example—Intercompany Profits from Upstream Sales 183

CHAPTER 6**Intercompany Profit Transactions—Plant Assets 207**

Intercompany Profits on Nondepreciable Plant Assets 207

Intercompany Profits on Depreciable Plant Assets 212

Plant Assets Sold at Other than Fair Value 220

Consolidation Example—Upstream and Downstream Sales of Plant Assets 221

Inventory Purchased for Use as Operating Assets 224

CHAPTER 7**Intercompany Profit Transactions—Bonds 239**

Intercompany Bond Transactions 239

Constructive Gains and Losses on Intercompany Bonds 240

Parent Bonds Purchased by Subsidiary 242

Subsidiary Bonds Purchased by Parent 248

CHAPTER 8**Consolidations—Changes in Ownership Interests 267**

Acquisitions during an Accounting Period 267

Piecemeal Acquisitions 270

Sale of Ownership Interests 272

Changes in Ownership Interests from Subsidiary Stock Transactions 278

Stock Dividends and Stock Splits by a Subsidiary 281

CHAPTER 9**Indirect and Mutual Holdings 297**

- Affiliation Structures 297
- Indirect Holdings—Father-Son-Grandson Structure 299
- Indirect Holdings—Connecting Affiliates Structure 302
- Mutual Holdings—Parent Stock Held by Subsidiary 306
- Subsidiary Stock Mutually Held 315

CHAPTER 10**Subsidiary Preferred Stock, Consolidated Earnings per Share,
and Consolidated Income Taxation 331**

- Subsidiaries with Preferred Stock Outstanding 331
- Parent and Consolidated Earnings Per Share 337
- Subsidiary with Convertible Preferred Stock 340
- Subsidiary with Options and Convertible Bonds 341
- Income Taxes of Consolidated Entities 342
- Income Tax Allocation 343
- Separate-Company Tax Returns with Intercompany Gain 346
- Effect of Consolidated and Separate-Company Tax Returns on
Consolidation Procedures 350
- Business Combinations 357
- Financial Statement Disclosures for Income Taxes 362

CHAPTER 11**Consolidation Theories, Push-Down Accounting, and Corporate Joint Ventures 381**

- Comparison of Consolidation Theories 382
- Illustration—Consolidation Under Parent-Company and Entity Theories 384
- Push-Down Accounting and Other Basis Considerations 393
- Joint Ventures 399
- Accounting for Variable Interest Entities 402

CHAPTER 12**Derivatives and Foreign Currency: Concepts and Common Transactions 421**

- Derivatives 421
- Foreign Exchange Concepts and Definitions 426
- Foreign Currency Transactions other than Forward Contracts 428

CHAPTER 13**Accounting for Derivatives and Hedging Activities 439**

- Accounting for Derivative Instruments and Hedging Activities 439
- Accounting for Hedge Contracts: Illustrations of Cash Flow and
Fair-Value Hedge Accounting Using Interest Rate Swaps 449
- Foreign Currency Derivatives and Hedging Activities 453

CHAPTER 14**Foreign Currency Financial Statements 473**

Objectives of Translation and the Functional Currency Concept 473

Application of the Functional Currency Concept 475

Illustration: Translation 479

Illustration: Remeasurement 485

Hedging a Net Investment in a Foreign Entity 489

CHAPTER 15**Segment and Interim Financial Reporting 507**

Segment Reporting 507

Interim Financial Reporting 513

Guidelines for Preparing Interim Statements 515

CHAPTER 16**Partnerships—Formation, Operations, and Changes in Ownership Interests 533**

Nature of Partnerships 533

Initial Investments in a Partnership 534

Additional Investments and Withdrawals 536

Partnership Operations 537

Profit- and Loss-Sharing Agreements 538

Changes in Partnership Interests 544

Purchase of an Interest from Existing Partners 545

Investing in an Existing Partnership 548

Dissociation of a Continuing Partnership through Death or Retirement 551

Limited Partnerships 553

CHAPTER 17**Partnership Liquidation 569**

The Liquidation Process 569

Safe Payments to Partners 573

Installment Liquidations 575

Cash Distribution Plans 581

Insolvent Partners and Partnerships 584

CHAPTER 18**Corporate Liquidations and Reorganizations 599**

Bankruptcy Reform Act of 1978 599

Liquidation 602

Illustration of a Liquidation Case 604

Reorganization 611

Financial Reporting during Reorganization 615

Financial Reporting for the Emerging Company 616

Illustration of a Reorganization Case 617

CHAPTER 19**An Introduction to Accounting for State and Local Governmental Units 633**

Historical Development of Accounting Principles for State and
Local Governmental Units 633

Overview of Basic Governmental Accounting Models and Principles 635

The Financial Reporting Entity 646

Comprehensive Annual Financial Report 647

CHAPTER 20**Accounting for State and Local Governmental Units—Governmental Funds 671**

Recent Changes to Governmental Fund Accounting 671

The General Fund 672

Accounting for the General Fund 672

Permanent Funds 685

Capital Projects Funds 686

Special Assessment Activities 691

Debt Service Funds 691

Governmental Fund Financial Statements 693

Preparing the Government-Wide Financial Statements 696

CHAPTER 21**Accounting for State and Local Governmental Units—Proprietary
and Fiduciary Funds 719**

Proprietary Funds 719

Internal Service Funds 720

Enterprise Funds 724

Proprietary Fund Financial Statements 727

Fiduciary Funds 729

Preparing the Government-Wide Financial Statements 734

Required Proprietary Fund Note Disclosures 734

CHAPTER 22**Accounting for Not-for-Profit Organizations 745**

The Nature of Not-for-Profit Organizations 745

Not-for-Profit Accounting Principles 746

Voluntary Health and Welfare Organizations 751

“Other” Not-for-Profit Organizations 758

Nongovernmental Not-for-Profit Hospitals and Other Health Care
Organizations 758

Private Not-for-Profit Colleges and Universities 762

CHAPTER 23

Estates and Trusts 781

Creation of an Estate 781

Probate Proceedings 782

Administration of the Estate 782

Accounting for the Estate 783

Illustration of Estate Accounting 784

Accounting for Trusts 788

Estate Taxation 789

Glossary G-1

Index I-1

PREFACE

NEW TO THIS EDITION

Important changes in the 12th edition of *Advanced Accounting* include the following:

- The text has been rewritten to align with both the *Financial Accounting Standards Board Accounting Standards Codification* and the *Governmental Accounting Standards Board Codification*. References to original pronouncements have been deleted, except where important in an historical context.
- The text now provides references to a listing of official pronouncements at the end of all chapters. Text length is reduced and rendered much more readable for the students.
- All chapters have been updated to include coverage of the latest international reporting standards and issues, where appropriate. As U.S. and international reporting standards move toward greater harmonization, the international coverage continues to expand in the 12th edition.
- All chapters have been updated to reflect the most recent changes to the *Financial Accounting Standards Board Codification* and *Governmental Accounting Standards Board Codification*.
 - Chapter 16 has been modified to clarify GAAP/non-GAAP issue with partnership accounting in instances where addition of a new partner may constitute a business combination.
- The governmental and not-for-profit chapters have been updated to include all standards through *GASB No. 70*. These chapters have also been enhanced with illustrations of the financial statements from Golden, Colorado. Coverage now includes the new financial statement elements (deferred inflows and outflows), as well as the new pension standards. Chapter 20 includes an exhibit with t-accounts to help students follow the governmental fund transactions and their financial statement impact.
- Chapter 23 coverage of fiduciary accounting for estates and trusts has been revised and updated to reflect current taxation of these entities as of December 31, 2013. Assignment materials have been modified to enhance student learning.

This 12th edition of *Advanced Accounting* is designed for undergraduate and graduate students majoring in accounting. This edition includes 23 chapters designed for financial accounting courses beyond the intermediate level. Although this text is primarily intended for accounting students, it is also useful for accounting practitioners interested in preparation or analysis of consolidated financial statements, accounting for derivative securities, and governmental and not-for-profit accounting and reporting. This 12th edition has been thoroughly updated to reflect recent business developments, as well as changes in accounting standards and regulatory requirements.

This comprehensive textbook addresses the practical financial reporting problems encountered in consolidated financial statements, goodwill, other intangible assets, and derivative securities. The text also includes coverage of foreign currency transactions and translations, partnerships, corporate liquidations and reorganizations, governmental accounting and reporting, not-for-profit accounting, and estates and trusts.

An important feature of the 12th edition is the continued student orientation, which has been further enhanced with this edition. This 12th edition strives to maintain an interesting and readable text for the students. The focus on the complete equity method is maintained to allow students to focus on accounting concepts rather than bookkeeping techniques in learning the consolidation materials. This edition also maintains the reference text quality of prior editions through the use of electronic supplements to the consolidation chapters provided on the Web site that accompanies this text, at www.pearsonglobaleditions.com/Beams. These electronic supplements have been decreased from eight in the prior edition to three in the current edition. Deleted materials from the electronic supplements have been integrated into the text chapters as appropriate. The presentation of consolidation materials highlights working paper–only entries with shading and presents working papers on single upright pages. All chapters include current excerpts from the popular business press and references to familiar real-world companies, institutions, and events. This book uses examples from annual reports of well-known companies and governmental and not-for-profit institutions to illustrate key concepts and maintain student interest. Assignment materials include adapted items from past CPA examinations and have been updated and expanded to maintain close alignment with coverage of the chapter concepts. Assignments have been updated to include additional research cases and simulation-type problems. This edition maintains identification of names of parent and subsidiary companies beginning with P and S, allowing immediate identification. It also maintains parenthetical notation in journal entries to clearly indicate the direction and types of accounts affected by the transactions. The 12th edition retains the use of learning objectives throughout all chapters to allow students to better focus study time on the most important concepts.

ORGANIZATION OF THIS BOOK

Chapters 1 through 11 cover business combinations, the equity, fair value and cost methods of accounting for investments in common stock, and consolidated financial statements. This emphasizes the importance of business combinations and consolidations in advanced accounting courses as well as in financial accounting and reporting practices.

Accounting and reporting standards for acquisitions are introduced in Chapter 1. Chapter 1 also provides necessary background material on the form and economic impact of business combinations. Chapter 2 introduces the complete equity method of accounting as a one-line consolidation, and this approach is integrated throughout subsequent chapters on consolidations. This approach permits alternate computations for such key concepts as consolidated net income and consolidated retained earnings, and it helps instructors explain the objectives of consolidation procedures. The alternative computational approaches also assist students by providing a check figure for their logic on these key concepts. The one-line consolidation is maintained as the standard for a parent company in accounting for investments in its subsidiaries. Chapter 3 introduces the preparation of consolidated financial statements. Students learn how to record the fair values of the subsidiary's identifiable net assets and implied goodwill. Chapter 4 continues consolidations coverage, introducing working paper techniques and procedures. The text emphasizes the three-section, vertical financial statement working paper approach throughout, but Chapter 4 also offers a trial balance approach in the appendix. The standard employed throughout the consolidation chapters is working papers for a parent company that uses the complete equity method of accounting for investments in subsidiaries.

Chapters 5 through 7 cover intercompany transactions in inventories, plant assets, and bonds. The Appendix to Chapter 5 reviews SEC accounting requirements.

Chapter 8 discusses changes in the level of subsidiary ownership, and Chapter 9 introduces more complex affiliation structures. Chapter 10 covers several consolidation-related topics: subsidiary preferred stock, consolidated earnings per share, and income taxation for consolidated business entities. Chapter 11 is a theory chapter that discusses alternative consolidation theories, push-down accounting, leveraged buyouts, corporate joint ventures, and key concepts related to accounting and reporting by variable interest entities. Chapters 9 through 11 cover specialized topics and have been written as stand-alone materials. Coverage of these chapters is not necessary for assignment of subsequent text chapters.

Business enterprises become more global in nature with each passing day. Survival of a modern business depends upon access to foreign markets, suppliers, and capital. Some of the unique

challenges of international business and financial reporting are covered in Chapters 12 and 13. These chapters cover accounting for derivatives and foreign currency transactions and translations. As in the prior edition, Chapter 12 covers the concepts and common transactions for derivatives and foreign currency, and Chapter 13 covers accounting for derivative and hedging activities. Coverage includes import and export activities and forward or similar contracts used to hedge against potential exchange losses. Chapter 14 focuses on preparation of consolidated financial statements for foreign subsidiaries. This chapter includes translation and remeasurement of foreign-entity financial statements, one-line consolidation of equity method investees, consolidation of foreign subsidiaries for financial reporting purposes, and the combination of foreign branch operations.

Chapter 15 introduces topics of segment reporting under *FASB ASC Topic 280*, as well as interim financial reporting issues. Partnership accounting and reporting are covered in Chapters 16 and 17. Chapter 16 has been updated to include consideration of cases where a partnership change meets the criteria for treatment as a business combination. Chapter 18 discusses accounting and reporting procedures related to corporate liquidations and reorganizations.

Chapters 19 through 21 provide an introduction to governmental accounting, and Chapter 22 introduces accounting for voluntary health and welfare organizations, hospitals, and colleges and universities. These chapters are completely updated through *GASB Statement No. 70*, and provide students with a good grasp of key concepts and procedures related to not-for-profit accounting.

Finally, Chapter 23 provides coverage of fiduciary accounting and reporting for estates and trusts.

INSTRUCTORS' RESOURCES

The supplements that accompany this text are available for instructors only to download at our Instructor Resource Center, at www.pearsonglobaleditions.com/Beams. Resources include the following:

- **Solutions manual:** Prepared by the authors, the solutions manual includes updated answers to questions, and solutions to exercises and problems. Solutions to assignment materials included in the electronic supplements are also included. Solutions are provided in electronic format, making electronic classroom display easier for instructors. All solutions have been accuracy-checked to maintain high-quality work.
- **Instructor's manual:** The instructor's manual contains comprehensive outlines of all chapters, class illustrations, descriptions for all exercises and problems (including estimated times for completion), and brief outlines of new standards set apart for easy review.
- **Test bank:** This file includes test questions in true/false, multiple-choice, short-answer, and problem formats. Solutions to all test items are also included.
- **PowerPoint presentation:** A ready-to-use PowerPoint slideshow designed for classroom presentation is available. Instructors can use it as-is or edit content to fit particular classroom needs.

STUDENT RESOURCES

To access the student download Web site, visit www.pearsonglobaleditions.com/Beams. This Web site includes the electronic supplements for certain chapters and problem templates.

ACKNOWLEDGMENTS

Many people have made valuable contributions to this 12th edition of *Advanced Accounting*, and we are pleased to recognize their contributions. We are indebted to the many users of prior editions for their helpful comments and constructive criticisms. We also acknowledge the help and encouragement that we received from students at Grand Valley State, Michigan State, and University of Washington, who, often unknowingly, participated in class testing of various sections of the manuscript.

We want to thank our faculty colleagues for the understanding and support that have made 12 editions of *Advanced Accounting* possible.

A special thank you to Carolyn Streuly for her many hours of hard work and continued dedication to the project.

The following accuracy checkers and supplements authors whose contributions we appreciate—Jeanne David, University Detroit Mercy; Darlene Ely, Carroll Community College, Linda Hajec, Penn State-Erie, The Behrend College; Sheila Handy, East Stroudsburg University.

We would like to thank the members of the Pearson book team for their hard work and dedication: Donna Battista, Vice President, Product Management; Heather McNally, Editorial Project Manager; Meredith Gertz, Production Project Manager. Haylee Schwenk, Project Manager, Lumina Datamatics, Inc.

Our thanks to the reviewers who helped to shape this 12th edition:

Marie Archambault, Marshall University	Bruce Oliver, Rochester Institute of Technology
Ron R. Barniv, Kent State University	Pamela Ondeck, University of Pittsburgh at Greensburg
Nat Briscoe, Northwestern State University	Anne Oppegard, Augustana College
Michael Brown, Tabor School of Business	Larry Ozzello, University of Wisconsin, Eau Claire
Susan Cain, Southern Oregon University	Glenda Partridge, Spring Hill College
Kerry Calnan, Elmus College	Thomas Purcell, Creighton University
Eric Carlsen, Kean University	Abe Qastin, Lakeland College
Gregory Cermignano, Widener University	Donna Randolph, National American University
Lawrence Clark, Clemson University	Frederick Richardson, Virginia Tech
Penny Clayton, Drury University	John Rossi, Moravian College
Lynn Clements, Florida Southern College	Angela Sandberg, Jacksonville State University
David Dahlberg, The College of St. Catherine	Mary Jane Saucedo, University of Texas at Brownville and Texas Southmost College
Patricia Davis, Keystone College	John Schatzel, Stonehill College
David Doyon, Southern New Hampshire University	Michael Schoderbeck, Rutgers University
John Dupuy, Southwestern College	Joann Segovia, Minnesota State University, Moorhead
Thomas Edmonds, Regis University	Stanley Self, East Texas Baptist University
Charles Fazzi, Saint Vincent College	Ray Slager, Calvin College
Roger Flint, Oklahoma Baptist University	Duane Smith, Brescia University
Margaret Garnsey, Siena College	Keith Smith, George Washington University
Sheri Geddes, Andrews University	Kimberly Smith, County College of Morris
Gary Gibson, Lindsey Wilson College	Pam Smith, Northern Illinois University
Bonnie Givens, Avila University	Jeffrey Spear, Houghton College
Steve Hall, University of Nebraska at Kearney	Catherine Staples, Randolph-Macon College
Matthew Henry, University of Arkansas at Pine Bluff	Natalie Strouse, Notre Dame College
Judith Harris, Nova Southeastern University	Zane Swanson, Emporia State University
Joyce Hicks, Saint Mary's College	Anthony Tanzola, Holy Family University
Marianne James, California State University, Los Angeles	Christine Todd, Colorado State University, Pueblo
Patricia Johnson, Canisius College	Ron Twedt, Concordia College
Stephen Kerr, Hendrix College	Barbara Uliss, Metropolitan State College of Denver
Thomas Largay, Thomas College	Joan Van Hise, Fairfield University
Stephani Mason, Hunter College	
Mike Metzcar, Indiana Wesleyan University	
Dianne R. Morrison, University of Wisconsin, La Crosse	
David O'Dell, McPherson College	

Dan Weiss, Tel Aviv University, Faculty
of Management

Stephen Wheeler, Eberhardt School of
Business

Deborah Williams, West Virginia State
University

H. James Williams, Grand Valley State
University

Joe Wilson, Muskingum College

Alex Yen, Suffolk University

Sung Wook Yoon, California State University,
Northridge

Suzanne Alonso Wright, Penn State

Ronald Zhao, Monmouth University

Pearson would like to thank and acknowledge the following people for their work on the Global Edition:

Contributors:

Gunawan Wibisono, Gadjah Mada University

Dayana Mastura, Asia Pacific University of
Technology and Innovation

Reviewers:

Debarshi Bhattacharya, SR Fatehpur College

Erkan Ilgun, International Burch University

Jeff Ng, The Chinese University of Hong Kong

ADVANCED ACCOUNTING

Business Combinations

- On December 31, 2008, *Wells Fargo & Company* acquired all of the outstanding shares of *Wachovia Corporation* for \$23.1 billion, making Wells Fargo one of the largest U.S. commercial banks.
- In October 2001, *Chevron* and *Texaco* announced completion of their merger agreement valued in excess of \$30 billion. In 1998, gasoline-producing rivals *Exxon* and *Mobil* merged to form *ExxonMobil* Corporation in a deal valued at \$80 billion.
- *Bank of America* acquired *FleetBoston Financial Corporation* for \$47 billion in 2004 and followed up with a purchase of *MBNA Corporation* for \$35 billion in 2005.

Welcome to the world of business combinations. The 1990s witnessed a period of unparalleled growth in merger and acquisition activities in both the United States and in international markets (often referred to as *merger mania*), and the trend continues.

Merger activities slowed with the stock market downturn in 2001, and again during the financial crisis of 2008, but as the market recovers, the pace has again picked up. The following firms announced combinations in 2013. *Steinway* (the piano manufacturer) agreed to be acquired by *Kohlberg & Co.* for \$438 million. *Nokia* bought out partner *Siemens AG's* 50% share in *Nokia Siemens Networks* for \$2.2 billion. Japan's *SoftBank* entered into an agreement to acquire *Sprint* for \$21.6 billion, subject to *Federal Communications Commission* approval. India's *Apollo Tyres* announced that it had agreed to acquire U.S. tire maker *Cooper Tire & Rubber Co.* for \$2.5 billion. *Shanghai International Holdings Ltd.* agreed to acquire *Smithfield Foods* for \$4.72 billion. Note the increasing globalization of merger and acquisition activities.

Firms strive to produce economic value added for shareholders. Related to this strategy, expansion has long been regarded as a proper goal of business entities. A business may choose to expand either internally (building its own facilities) or externally (acquiring control of other firms in business combinations). The focus in this chapter is on why firms often prefer external over internal expansion options and how financial reporting reflects the outcome of these activities.

In general terms, **business combinations** unite previously separate business entities. The overriding objective of business combinations must be increasing profitability; however, many firms can become more efficient by horizontally or vertically integrating operations or by diversifying their risks through conglomerate operations.

Horizontal integration is the combination of firms in the same business lines and markets. The combinations of Chevron and Texaco, Exxon and Mobil, and Wells Fargo and Wachovia are

LEARNING OBJECTIVES

- 1 Understand the economic motivations underlying business combinations.
- 2 Learn about alternative forms of business combinations, from both the legal and accounting perspectives.
- 3 Introduce accounting concepts for business combinations, emphasizing the acquisition method.
- 4 See how firms record fair values of assets and liabilities in an acquisition.

EXHIBIT 1-1

Segment Reporting
at General Electric

Source: 2012 General Electric annual report (p. 191).

NOTE 28: OPERATING SEGMENTS			
Revenues (in millions)			
	<i>Total Revenues</i>		
	2012	2011	2010
Power & Water	\$ 28,299	\$ 25,675	\$ 24,779
Oil & Gas	15,241	13,608	9,433
Energy management	7,412	6,422	5,161
Aviation	19,994	18,859	17,619
Healthcare	18,290	18,083	16,897
Transportation	5,608	4,885	3,370
Home & Business Solutions	<u>7,967</u>	<u>7,693</u>	<u>7,957</u>
Total industrial	102,811	95,225	85,216
GE Capital	46,039	49,068	49,856
Corporate items and eliminations	<u>(1,491)</u>	<u>2,995</u>	<u>14,495</u>
Total	<u>\$147,359</u>	<u>\$147,288</u>	<u>\$149,567</u>

The note goes on to provide similar detailed breakdown of intersegment revenues; external revenues; assets; property, plant, and equipment additions; depreciation and amortization; interest and other financial charges; and the provision for income taxes.

examples of horizontal integration. The past 20 years have witnessed significant consolidation activity in banking and other industries. *Kimberly-Clark* acquired *Scott Paper*, creating a consumer paper and related products giant. *Delta Air Lines* took control of its rival *Northwest Air Lines* in 2008 at a cost of \$3.353 billion. Office product supplier *Office Depot* acquired rival *OfficeMax* in 2013 in a deal valued at \$1.2 billion.

Vertical integration is the combination of firms with operations in different, but successive, stages of production or distribution, or both. In March 2007, *CVS Corporation* and *Caremark Rx, Inc.*, merged to form *CVS/Caremark Corporation* in a deal valued at \$26 billion. The deal joined the nation's largest pharmacy chain with one of the leading healthcare/pharmaceuticals service companies.

Conglomeration is the combination of firms with unrelated and diverse products or service functions, or both. Firms may diversify to reduce the risk associated with a particular line of business or to even out cyclical earnings, such as might occur in a utility's acquisition of a manufacturing company. Several utilities combined with telephone companies after the 1996 Telecommunications Act allowed utilities to enter the telephone business. The early 1990s saw tobacco maker *Phillip Morris Company* acquire food producer *Kraft* in a combination that included over \$11 billion of recorded goodwill alone. Although all of us have probably purchased a light bulb manufactured by *General Electric Company*, the scope of the firm's operations goes well beyond that household product. Exhibit 1-1 excerpts Note 28 from General Electric's 2012 annual report on its major operating segments.

LEARNING
OBJECTIVE 1**REASONS FOR BUSINESS COMBINATIONS**

If expansion is a proper goal of business enterprise, why would a business expand through combination rather than by building new facilities? Among the many possible reasons are the following:

Cost Advantage. It is frequently less expensive for a firm to obtain needed facilities through combination than through development. This is particularly true in periods of inflation. Reduction of the total cost for research and development activities was a prime motivation in *AT&T's* acquisition of *NCR*.

Lower Risk. The purchase of established product lines and markets is usually less risky than developing new products and markets. The risk is especially low when the goal is diversification. Scientists may discover that a certain product provides an environmental or health hazard. A single-product, nondiversified firm may be forced into bankruptcy by such a discovery, whereas a multiproduct, diversified company is more likely to survive. For companies in industries already plagued with excess manufacturing capacity, business combinations may be the only way to grow. When *Toys R Us* decided to diversify its operations to include baby furnishings and other related products, it purchased retail chain *Baby Superstore*.

Fewer Operating Delays. Plant facilities acquired in a business combination are operative and already meet environmental and other governmental regulations. The time to market is critical, especially in the technology industry. Firms constructing new facilities can expect numerous delays in construction, as well as in getting the necessary governmental approval to commence operations. Environmental impact studies alone can take months or even years to complete.

Avoidance of Takeovers. Many companies combine to avoid being acquired themselves. Smaller companies tend to be more vulnerable to corporate takeovers; therefore, many of them adopt aggressive buyer strategies to defend against takeover attempts by other companies.

Acquisition of Intangible Assets. Business combinations bring together both intangible and tangible resources. The acquisition of patents, mineral rights, research, customer databases, or management expertise may be a primary motivating factor in a business combination. When *IBM* purchased *Lotus Development Corporation*, \$1.84 billion of the total cost of \$3.2 billion was allocated to research and development in process.

Other Reasons. Firms may choose a business combination over other forms of expansion for business tax advantages (e.g., tax-loss carryforwards), for personal income and estate-tax advantages, or for personal reasons. One of several motivating factors in the combination of *Wheeling-Pittsburgh Steel*, a subsidiary of *WHX*, and *Handy & Harman* was Handy & Harman's overfunded pension plan, which virtually eliminated Wheeling-Pittsburgh Steel's unfunded pension liability. The egos of company management and takeover specialists may also play an important role in some business combinations.

ANTITRUST CONSIDERATIONS

Federal antitrust laws prohibit business combinations that restrain trade or impair competition. The U.S. Department of Justice and the Federal Trade Commission (FTC) have primary responsibility for enforcing federal antitrust laws. For example, in 1997 the FTC blocked *Staples's* proposed \$4.3 billion acquisition of *Office Depot*, arguing in federal court that the takeover would be anti-competitive. As noted earlier *Office Depot* acquired rival *OfficeMax* in 2013.

In 2004, the FTC conditionally approved *Sanofi-Synthelabo SA's* \$64 billion takeover of *Aventis SA*, creating the world's third-largest drug manufacturer. Sanofi agreed to sell certain assets and royalty rights in overlapping markets in order to gain approval of the acquisition.

Business combinations in particular industries are subject to review by additional federal agencies. The Federal Reserve Board reviews bank mergers, the Department of Transportation scrutinizes mergers of companies under its jurisdiction, the Department of Energy has jurisdiction over some electric utility mergers, and the Federal Communications Commission (FCC) rules on the transfer of communication licenses. After the Justice Department cleared a \$23 billion merger between *Bell Atlantic Corporation* and *Nynex Corporation*, the merger was delayed by the FCC because of its concern that consumers would be deprived of competition. The FCC later approved the merger. The merger of *U.S. Airways* and *American Airlines* faced delay and scrutiny over the reduced competitive environment, but was approved in December, 2013.

In addition to federal antitrust laws, most states have some type of statutory takeover regulations. Some states try to prevent or delay hostile takeovers of the business enterprises incorporated within their borders. On the other hand, some states have passed antitrust exemption laws to protect hospitals from antitrust laws when they pursue cooperative projects.

Interpretations of antitrust laws vary from one administration to another, from department to department, and from state to state. Even the same department under the same administration can change its mind. A completed business combination can be re-examined by the FTC at any time. Deregulation in the banking, telecommunication, and utility industries permits business combinations that once would have been forbidden. In 1997, the Justice Department and the FTC jointly issued new guidelines for evaluating proposed business combinations that allow companies to argue that cost savings or better products could offset potential anticompetitive effects of a merger.

LEARNING
OBJECTIVE 2

LEGAL FORM OF BUSINESS COMBINATIONS

Business combination is a general term that encompasses all forms of combining previously separate business entities. Such combinations are **acquisitions** when one corporation acquires the productive assets of another business entity and integrates those assets into its own operations. Business combinations are also acquisitions when one corporation obtains operating control over the productive facilities of another entity by acquiring a majority of its outstanding voting stock. The acquired company need not be dissolved; that is, the acquired company does not have to go out of existence.

The terms **merger** and **consolidation** are often used as synonyms for acquisitions. However, legally and in accounting there is a difference. A merger entails the dissolution of all but one of the business entities involved. A consolidation entails the dissolution of all the business entities involved and the formation of a new corporation.

A *merger* occurs when one corporation takes over all the operations of another business entity, and that entity is dissolved. For example, Company A purchases the assets of Company B directly from Company B for cash, other assets, or Company A securities (stocks, bonds, or notes). This business combination is an acquisition, but it is not a merger unless Company B goes out of existence. Alternatively, Company A may purchase the stock of Company B directly from Company B's stockholders for cash, other assets, or Company A securities. This acquisition will give Company A operating control over Company B's assets. It will not give Company A legal ownership of the assets unless it acquires all the stock of Company B and elects to dissolve Company B (again, a merger).

A *consolidation* occurs when a new corporation is formed to take over the assets and operations of two or more separate business entities and dissolves the previously separate entities. For example, Company D, a newly formed corporation, may acquire the net assets of Companies E and F by issuing stock directly to Companies E and F. In this case, Companies E and F may continue to hold Company D stock for the benefit of their stockholders (an acquisition), or they may distribute the Company D stock to their stockholders and go out of existence (a consolidation). In either case, Company D acquires ownership of the assets of Companies E and F.

Alternatively, Company D could issue its stock directly to the stockholders of Companies E and F in exchange for a majority of their shares. In this case, Company D controls the assets of Company E and Company F, but it does not obtain legal title unless Companies E and F are dissolved. Company D must acquire all the stock of Companies E and F and dissolve those companies if their business combination is to be a consolidation. If Companies E and F are not dissolved, Company D will operate as a holding company, and Companies E and F will be its subsidiaries.

Future references in this chapter will use the term *merger* in the technical sense of a business combination in which all but one of the combining companies go out of existence. Similarly, the term *consolidation* will be used in its technical sense to refer to a business combination in which all the combining companies are dissolved, and a new corporation is formed to take over their net assets. *Consolidation* is also used in accounting to refer to the accounting process of combining parent and subsidiary financial statements, such as in the expressions "principles of consolidation," "consolidation procedures," and "consolidated financial statements." In future chapters, the meanings of the terms will depend on the context in which they are found.

Mergers and consolidations do not present special accounting problems or issues after the initial combination, apart from those discussed in intermediate accounting texts. This is because only one legal and accounting entity survives in a merger or consolidation.

ACCOUNTING CONCEPT OF BUSINESS COMBINATIONS

GAAP defines the accounting concept of a business combination as:

A transaction or other event in which an acquirer obtains control of one or more businesses. Transactions sometimes referred to as true mergers or mergers of equals also are business combinations. [1]

Note that the accounting concept of a business combination emphasizes the creation of a single entity and the independence of the combining companies before their union. Although one or more of the companies may lose its separate legal identity, dissolution of the legal entities is not necessary within the accounting concept.

Previously separate businesses are brought together into one entity when their business resources and operations come under the control of a single management team. Such control within one business entity is established in business combinations in which:

1. One or more corporations become subsidiaries;
2. One company transfers its net assets to another; or
3. Each company transfers its net assets to a newly formed corporation.

A corporation becomes a **subsidiary** when another corporation acquires a majority (more than 50 percent) of its outstanding voting stock. Thus, one corporation need not acquire all of the stock of another corporation to consummate a business combination. In business combinations in which less than 100 percent of the voting stock of other combining companies is acquired, the combining companies necessarily retain separate legal identities and separate accounting records even though they have become one entity for financial reporting purposes.

Business combinations in which one company transfers its net assets to another can be consummated in a variety of ways, but the acquiring company must acquire substantially all the net assets in any case. Alternatively, each combining company can transfer its net assets to a newly formed corporation. Because the newly formed corporation has no net assets of its own, it issues its stock to the other combining companies or to their stockholders or owners.

A Brief Background on Accounting for Business Combinations

Accounting for business combinations is one of the most important and interesting topics of accounting theory and practice. At the same time, it is complex and controversial. Business combinations involve financial transactions of enormous magnitudes, business empires, success stories and personal fortunes, executive genius, and management fiascos. By their nature, they affect the fate of entire companies. Each is unique and must be evaluated in terms of its economic substance, irrespective of its legal form.

Historically, much of the controversy concerning accounting requirements for business combinations involved the **pooling of interests method**, which became generally accepted in 1950. Although there are conceptual difficulties with the pooling method, the underlying problem that arose was the introduction of alternative methods of accounting for business combinations (pooling versus purchase). Numerous financial interests are involved in a business combination, and alternate accounting procedures may not be neutral with respect to different interests. That is, the individual financial interests and the final plan of combination may be affected by the method of accounting.

Until 2001, accounting requirements for business combinations recognized both the pooling and purchase methods of accounting for business combinations. In August 1999, the Financial Accounting Standards Board (FASB) issued a report supporting its proposed decision to eliminate pooling. Principal reasons cited included the following:

- Pooling provides less relevant information to statement users.
- Pooling ignores economic value exchanged in the transaction and makes subsequent performance evaluation impossible.
- Comparing firms using the alternative methods is difficult for investors.

Pooling creates these problems because it uses historical book values to record combinations, rather than recognizing fair values of net assets at the transaction date. Generally accepted accounting principles (GAAP) generally require recording asset acquisitions at fair values.