

This International Student Edition is for use outside of the U.S.

Advanced THIRTEENTH EDITION
FINANCIAL ACCOUNTING

Christensen
Cottrell
Budd

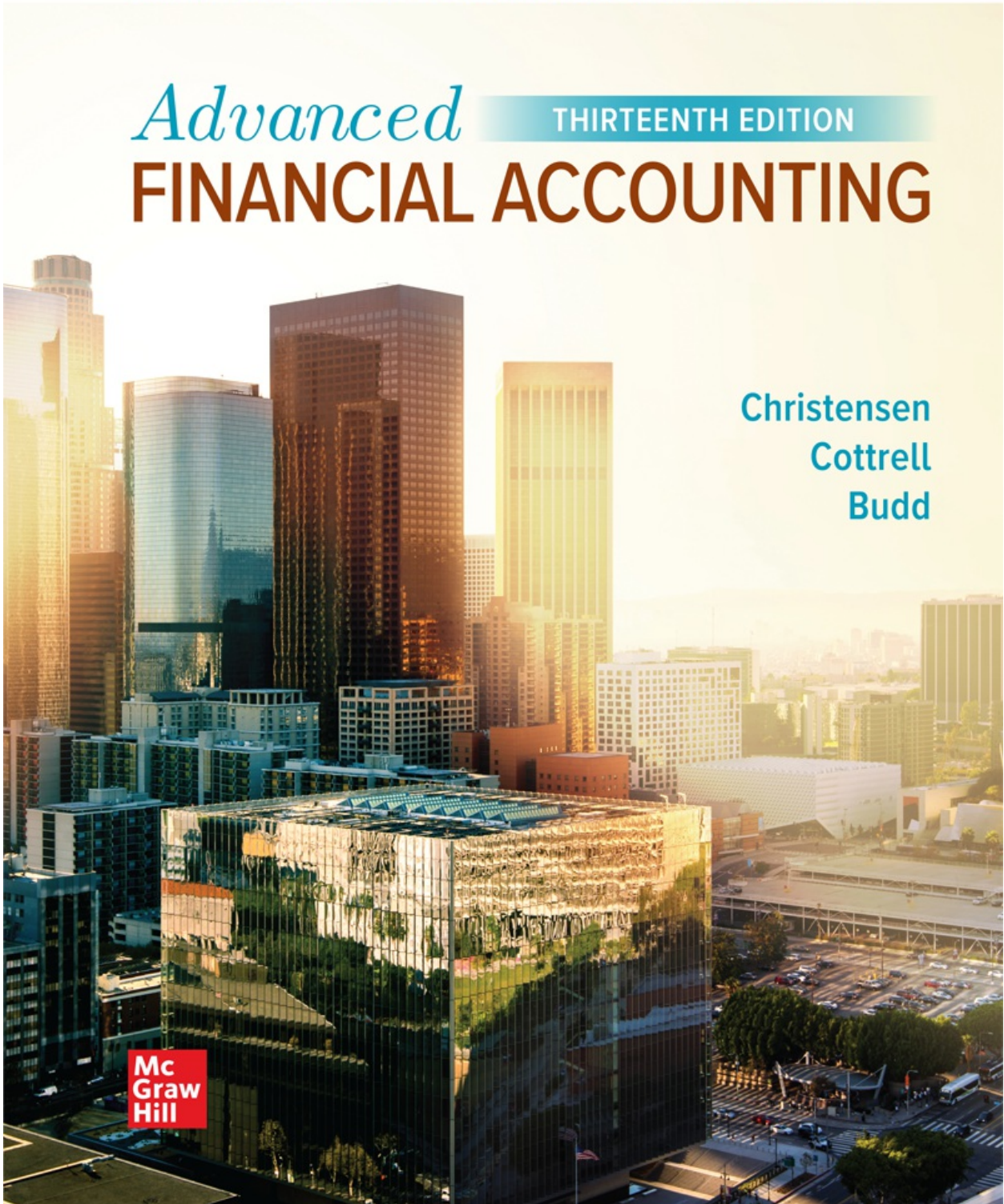
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Advanced Financial Accounting

Advanced Financial Accounting

Thirteenth Edition



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Brigham Young University

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ADVANCED FINANCIAL ACCOUNTING

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About the Authors



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Ted Christensen has been a faculty member at the University of Georgia since 2015. Prior to coming to UGA, he was on the faculty at Brigham Young University for 15 years and Case Western Reserve University for five years. He received a BS degree in accounting at San Jose State University, a MAcc degree in tax at Brigham Young University, and a PhD in accounting from the University of Georgia (so he is now teaching at a second alma mater). Professor Christensen has authored and coauthored articles published in many journals including *The Accounting Review*, *Journal of Accounting Research*, *Journal of Accounting and Economics*, *Review of Accounting Studies*, *Contemporary Accounting Research*, *Accounting Organizations and Society*, *Journal of Business Finance & Accounting*, *Accounting Horizons*, and *Issues in Accounting Education*. Professor Christensen has taught financial accounting at all levels, financial statement analysis, both

introductory and intermediate managerial accounting, and corporate taxation. He is the recipient of numerous awards for both teaching and research. He has been active in serving on various committees of the American Accounting Association and is a CPA.



Courtesy Brigham Young University/Photo by Kristen Gudmund

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



Courtesy Brigham Young University/Photo by Tabitha Sumsion

Cassy JH Budd

Professor Budd has been a faculty member at Brigham Young University since 2005. Prior to coming to BYU, she was on the faculty at Utah State University for three years. She received a BS degree in accounting at Brigham Young University and a MAcc degree in tax at Utah State University. Before pursuing a career in academics, she worked as an auditor for the firm of PricewaterhouseCoopers LLP in its Salt Lake, San Jose, and Phoenix offices and continues to maintain her CPA license. Professor Budd has taught financial accounting at all levels, as well as managerial accounting, undergraduate and graduate auditing, and partnership taxation. She is the recipient of numerous awards for teaching and student advisement, including the BYU Marriott School Teaching Excellence Award; the Dean Fairbanks Teaching and Learning Faculty Fellowship, Brigham Young University; School of Accountancy Advisor of the Year, Utah State University; State of Utah Campus Compact Service-Learning Engaged Scholar Award; and the Joe Whitesides Scholar–Athlete Recognition page vi Award from Utah State University. She has been active in serving on various committees of the American Accounting Association (AAA), including serving as president of the AAA Teaching, Learning and Curriculum section and chairing the annual Conference on Teaching and Learning in Accounting. Professor Budd is currently serving as the AAA Council Representative for the Teaching, Learning and Curriculum Section.

Preface



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

OVERVIEW

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

Multicorporate Entities

Business Combinations

1. Intercorporate Acquisitions and Investments in Other Entities

Consolidation Concepts and Procedures

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

Intercompany Transactions

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

Additional Consolidation Issues

9. Consolidation Ownership Issues
10. Additional Consolidation Reporting Issues

Multinational Entities

Foreign Currency Transactions

11. Multinational Accounting: Foreign Currency Transactions and Financial Instruments

Translation of Foreign Statements

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

page viii

Reporting Requirements

Segment and Interim Reporting

13. Segment and Interim Reporting

SEC Reporting

14. SEC Reporting

Partnerships

Formation, Operation, Changes

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

Liquidation

16. Partnerships: Liquidation

Governmental and Not-for-Profit Entities

Governmental Entities

17. Governmental Entities: Introduction and General Fund Accounting

Special Funds

18. Governmental Entities: Special Funds and Governmentwide Financial Statements

Not-for-Profit Entities

19. Not-for-Profit Entities

Corporations in Financial Difficulty

20. Corporations in Financial Difficulty

NEW FEATURES FOR THE THIRTEENTH EDITION



Videos. The Thirteenth Edition of *Advanced Financial Accounting* continues one of the most student-centered technology supplements ever delivered in the advanced accounting market by moving the AdvancedStudyGuide.com into Connect. This content was created

exclusively by the text authors. It contains dozens of narrated, animated discussions and explanations of material aligned to key points in the chapter as well as animated problems just like key problems in the exercises and problems at the end of each chapter. Within the text, the Advanced Study Guide icon denotes where materials that go beyond the printed text are available.

Integrated Excel. New assignments pair the power of Microsoft Excel with the power of Connect. A seamless integration of Excel within Connect, Integrated Excel questions allow students to work in live, auto-graded Excel spreadsheets - no additional logins, no need to upload or download files. Instructors can choose to grade by formula or solution value, and students receive instant cell-level feedback via integrated Check My Work functionality.

KEY FEATURES MAINTAINED IN THE THIRTEENTH EDITION

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

Shading of consolidation worksheet entries. The full-color coordination of all consolidation items allows teachers and students to see the development of each item and trace these items visually through the consolidation process. For example, each number in the Book Value Calculations can be traced to the Basic Consolidation Entry.

Book Value Calculations:

	NCI 20%	Peerless 80%	=	Common Stock	+	Retained Earnings
Original Book Value	60,000	240,000		200,000		100,000
+ Net Income	10,000	40,000				50,000
- Dividends	(6,000)	(24,000)				(30,000)
Ending Book Value	64,000	256,000		200,000		120,000

The boxed numbers in the chart above comprise the basic consolidation entry:

Basic Consolidation Entry:		
Common Stock	200,000	← Common stock balance
Retained Earnings	100,000	← Beginning balance in RE
Income from Special Foods	40,000	← Peerless's share of Special Foods' NI
NCI in NI of Special Foods	10,000	← NCI's share of Special Foods' NI
Dividends Declared	30,000	← 100% of Special Foods' dividends
Investment in Special Foods	256,000	← Peerless's share of Special Foods' BV
NCI in NA of Special Foods	64,000	← NCI's share of net amount of BV

Likewise, the calculations in the Excess Value (Differential) Calculations can be traced to either the Amortized Excess Value Reclassification Entry or the Excess Value (Differential) Reclassification Entry. In the Computation table, color application helps users to quickly and clearly distinguish between Amortization amounts related to the current year and the current year Ending Balance for each item and connect these calculations to the consolidation entries.

Users can continue using colors to quickly connect the impact of the consolidation entries as they visualize how each of these entries impacts the equity accounts. With these connections, users can follow items through calculations, consolidation entries, and T-accounts. This approach helps users to see the interaction of the equity entries and the consolidation entries in fully eliminating the “Investment in Sub” and the “Income from Sub Accounts.” The visual connections continue from the entries and the T-accounts all the way through the consolidation worksheets, supporting schedules, and calculation boxes so that numbers appearing in consolidation worksheet entries are uniformly shaded in all locations.

Excess Value (Differential) Calculations:

	NCI 20%	Peerless 80%	=	Inventory	+	Land	+	Building	+	Acc. Depr.	+	Goodwill
Beginning Balance	17,500	70,000		5,000		10,000		60,000		0		12,500
Amortization	(2,825)	(11,300)		(5,000)						(6,000)		(3,125)
Ending Balance	14,675	58,700		0		10,000		60,000		(6,000)		9,375

Amortized Excess Value Reclassification Entry:

Cost of Goods Sold	5,000	← Extra cost of goods sold
Depreciation Expense	6,000	← Depreciation of excess building value
Goodwill Impairment Loss	3,125	← Goodwill impairment
Income from Special Foods	11,300	← Peerless's share of amortization
NCI in NI of Special Foods	2,825	← NCI's share of amortization

Excess Value (Differential) Reclassification Entry:

Land	10,000	← Remaining excess value
Buildings & Equipment	60,000	← Remaining excess value
Goodwill	9,375	← Calculated value from acquisition
Accumulated Depreciation	6,000	← Excess building value ÷ 10 years
Investment in Special Foods	58,700	← Peerless's share of differential
NCI in NA of Special Foods	14,675	← NCI's share of differential

	Investment in Special Foods		Income from Special Foods	
Acquisition Price	310,000			
80% of NI	40,000		40,000	80% of NI
	24,000	80% Div		
	11,300	80% of Excess Amortization	11,300	
Ending Balance	314,700	Basic	28,700	Ending Balance
	256,000	Excess Value Reclassification	11,300	Amort. Reclassification
	58,700			
	0		0	

Callout boxes. We have updated the “callout boxes” that appear in the margins to draw attention to important points throughout the chapters. The most common callout boxes are the “FYI” boxes, which often illustrate how real-world companies or entities apply the principles discussed in the various chapters. The “Caution” boxes draw students’ attention to common mistakes and explain how to avoid them. The “Stop & Think” boxes help students take a step back and think through the logic of difficult concepts.

FIGURE 5-4 December 31, 20X1, Equity-Method Worksheet for Consolidated Financial Statements, Initial Year of Ownership; 80 Percent Acquisition at More than Book Value

	Peerless Products	Special Foods	Consolidation Entries		Consolidated
			DR	CR	
Income Statement					
Sales	400,000	200,000			600,000
Less: COGS	(170,000)	(115,000)	5,000		(290,000)
Less: Depreciation Expense	(50,000)	(20,000)	6,000		(76,000)
Less: Other Expenses	(40,000)	(15,000)			(55,000)
Less: Impairment Loss			3,125		(3,125)
Income from Special Foods	28,700		40,000	11,300	0
Consolidated Net Income	168,700	50,000	54,125	11,300	175,875
NCI in Net Income			10,000	2,825	(7,175)
Controlling Interest in Net Income	168,700	50,000	64,125	14,125	168,700
Statement of Retained Earnings					
Beginning Balance	300,000	100,000	100,000		300,000
Net Income	168,700	50,000	64,125	14,125	168,700
Less: Dividends Declared	(60,000)	(30,000)		30,000	(60,000)
Ending Balance	408,700	120,000	164,125	44,125	408,700
Balance Sheet					
Cash	194,000	75,000			269,000
Accounts Receivable	75,000	50,000			125,000
Inventory	100,000	75,000			175,000
Investment in Special Foods	314,700			256,000	0
				58,700	
Land	175,000	40,000	10,000		225,000
Buildings & Equipment	800,000	600,000	60,000	300,000	1,160,000
Less: Accumulated Depreciation	(450,000)	(320,000)	300,000	6,000	(476,000)
Goodwill			9,375		9,375
Total Assets	1,208,700	520,000	379,375	620,700	1,487,375
Accounts Payable	100,000	100,000			200,000
Bonds Payable	200,000	100,000			300,000
Common Stock	500,000	200,000	200,000		500,000
Retained Earnings	408,700	120,000	164,125	44,125	408,700
NCI in NA of Special Foods				64,000	78,675
				14,675	
Total Liabilities & Equity	1,208,700	520,000	364,125	122,800	1,487,375

FASB codification. Authoritative citations to U.S. GAAP are cited based on the FASB codification.

Introductory vignettes. Each chapter begins with a brief story of a well-known company to illustrate why topics covered in that chapter are relevant in current practice. Short descriptions of the vignettes and the featured companies are included in the Chapter-by-Chapter Changes section at the end of the Preface.

A building-block approach to consolidation. Virtually all advanced financial accounting classes cover consolidation topics. Although this topic

is perhaps the most important to instructors, students frequently struggle to gain a firm grasp of consolidation principles. The Thirteenth Edition provides students a learning-friendly framework to consolidations by introducing consolidation concepts and procedures more gradually. This is accomplished by a building-block approach that introduces consolidations in Chapters 2 and 3 and continues through Chapter 5.

IFRS comparisons. While the FASB and IASB had worked toward convergence to a single set of global accounting standards in the past, differences between the two frameworks persist. The Thirteenth Edition summarizes existing key differences between current U.S. GAAP and IFRS where applicable.

The use of a continuous case for each major subject-matter area. This textbook presents the complete story of a company, Peerless Products Corporation, from its beginning through its growth to a multinational consolidated entity and finally to its end. At each stage of the entity's development, including the acquisition of a subsidiary, Special Foods Inc., the text presents comprehensive examples and discussions of the accounting and financial reporting issues that accountants face. The discussions tied to the Peerless Products continuous case are easily identified by the company logos in the margin:



We use the comprehensive case of Peerless Products Corporation and its subsidiary, Special Foods Inc., throughout the for-profit chapters. For the governmental chapters, the Sol City case facilitates the development of governmental accounting and reporting concepts and procedures. Using a continuous case provides several benefits. First, students need to become familiar with only one set of data and can then move more quickly through the subsequent discussion and illustrations without having to absorb a new set of data. Second, the case adds realism to the study of advanced accounting and permits students to see the effects of each successive step on an entity's financial reports. Finally, comparing and contrasting alternative methods using a continuous case allows students to evaluate different methods and outcomes more readily.

Extensive illustrations of key concepts. The book is heavily illustrated with complete, not partial, workpapers, financial statements, and other computations and comparisons useful for demonstrating each topic. The illustrations are cross-referenced to the relevant text discussion. In the consolidations portion of the text, the focus is on the fully adjusted equity method of accounting for an investment in a subsidiary, but two other methods—the cost method and the modified equity method—are also discussed and illustrated in chapter appendixes.

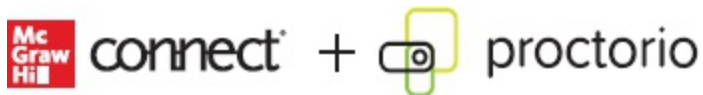
Comprehensive coverage with significant flexibility. The subject matter of advanced accounting is expanding at an unprecedented rate. New topics are being added, and traditional topics require more extensive coverage. Flexibility is therefore essential in an advanced accounting text. Most one-term courses are unable to cover all topics included in this text. In recognition of time constraints, this text is structured to provide the most efficient use of the time available. The self-contained units of subject matter allow for substantial flexibility in sequencing the course materials. In addition, individual chapters are organized to allow for more depth page xii in some topics through the use of the “Additional Considerations” sections. Several chapters include appendixes containing discussions of alternative accounting procedures or illustrations of procedures or concepts that are of a supplemental nature.

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

Internet, or other inquiry processes to answer the questions presented on the topics in the chapters.

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Choose the best format for your course: color print, black-and-white print, or eBook. The eBook can be included in your Connect course and is available on the free ReadAnywhere app for smartphone or tablet access as well. When you are finished customizing, you will receive a free digital copy to review in just minutes! Visit McGraw Hill Create®—www.mcgrawhillcreate.com—today and begin building!

ASSURANCE OF LEARNING READY

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

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

AACSB STATEMENT

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

The statements contained in *Advanced Financial Accounting* Thirteenth Edition are provided only as a guide for the users of this textbook. The

AACSB leaves content coverage and assessment within the purview of individual schools, the mission of the school, and the faculty. Although *Advanced Financial Accounting* Thirteenth Edition and the teaching package make no claim of any specific AACSB qualification or evaluation, we have within *Advanced Financial Accounting* Thirteenth Edition labeled selected questions according to the six general knowledge and skills areas.

ROGER CPA



McGraw Hill Education has partnered with Roger CPA Review, a global leader in CPA Exam preparation, to provide students a smooth transition from the accounting classroom to successful completion of the CPA Exam. While many aspiring accountants wait until they have completed their academic studies to begin preparing for the CPA Exam, research shows that those who become familiar with exam content earlier in the process have a stronger chance of successfully passing the CPA Exam. Accordingly, students using these McGraw Hill materials will have access to sample CPA Exam Task-based Simulations from Roger CPA Review, with expert-written explanations and solutions. All questions are either directly from the AICPA or are modeled on AICPA questions that appear in the exam. Task-based Simulations are delivered via the Roger CPA Review platform, which mirrors the look, feel, and functionality of the actual exam. McGraw Hill Education and Roger CPA Review are dedicated to supporting every accounting student along their journey, ultimately helping them achieve career success in the accounting profession. For more information about the full Roger CPA Review program, exam requirements, and exam content, visit www.rogercpareview.com.

CHAPTER-BY-CHAPTER CHANGES IN THE THIRTEENTH EDITION

Chapter 1 emphasizes the importance of business acquisitions and combinations. The chapter has been significantly reorganized and updated based on feedback from textbook adopters to provide a clearer and more concise discussion of the accounting treatment of mergers, acquisitions, and other intercorporate investments. We have substantially revised the chapter and updated the beginning-of-chapter vignette and callout boxes to provide updated real-world examples of the topics discussed in the chapter. We include a new opening vignette about the T-Mobile merger with Sprint.

Chapter 2 summarizes the different types of intercorporate investments. The coverage in this chapter, which is specific to accounting for equity securities, has been updated consistent with ASU 2016-01, which is codified into ASC 321. This chapter also introduces consolidation in the most straightforward scenario—where the parent company acquires full ownership of the subsidiary for an amount equal to the subsidiary’s book value (i.e., no differential). This chapter introduces a method of shading our consolidation worksheet entries to make them easily distinguishable by the reader. We have updated this chapter to provide a more streamlined and understandable coverage of topics traditionally included in this chapter. Finally, we have updated the “callout boxes” that provide real-world examples of the topics discussed in the chapter, some of which provide additional information about **Berkshire Hathaway’s** investments discussed in the introductory vignette.

Chapter 3 explores how the basic consolidation process differs when a subsidiary is only partially owned. Moreover, it introduces the notion of special-purpose entities and accounting standards related to variable interest entities (VIE) by discussing the **Coca-Cola Company**. This chapter includes updated FASB guidance in ASC 810 related to the characteristics of a VIE and the primary beneficiary or reporting entity. In addition, we have updated the callout boxes to help students understand the intricacies associated with the consolidation of a partially owned subsidiary and dealing with variable interest entities.

Chapter 4 gives a behind-the-scenes look at the work that goes into the consolidation process based on **Disney Corporation** including its now controlling investment in BAMTech, which holds Major League Baseball’s streaming technology and content delivery business. This chapter introduces consolidation of wholly owned subsidiaries with a differential, which results

in situations in which the acquiring company pays more than the book value of the acquired company's net assets. A new example of this differential is highlighted with Microsoft's acquisition of GitHub. This chapter adds a detailed explanation of the shading of the consolidation worksheet entries introduced in Chapter 2.

Chapter 5 introduces majority ownership of subsidiaries based on the 51 percent acquisition of **Massmart** by **Walmart**. We further the discussion of acquisitions with a differential that has the added complexity of noncontrolling interest shareholders when they purchase less than 100 percent of the outstanding common stock. We have simplified the coverage of some of the topics in this chapter and removed tangential topics to provide more concise coverage of the important material.

Chapter 6 introduces intercompany inventory transfers based on **Samsung Electronics** and its subsidiaries, which accounted for 57 percent of Samsung's total revenues in 2019. The elimination of intercompany profits can become complicated. In fact, intercompany inventory transactions and the consolidated procedures associated with them represent one of the topics textbook adopters have found most difficult to teach to students. As a result, we have rewritten this with added illustrations to better simplify adjustments to the basic consolidation entry in both the year when an intercompany sale of inventory leads to a deferral of gross profit (Year 1) and the next year when this deferral is reversed (Year 2). In addition, we have updated a series of new callout boxes to draw students' attention to the subtle complexities that our students have frequently struggled to understand.

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

Chapter 8 begins with a new example of how intercompany indebtedness played a significant role in the resolution of the bankruptcy of **Caesars**

Entertainment Corporation's (CEC) largest casino operating subsidiary, **Caesars Entertainment Operating Company, Inc.** (CEOC). New to this edition are detailed calculation explanations for all Bond Amortizations, Present Values, and Future Values, illustrated in the chapter examples. These new explanations also illustrate how these calculations can all be performed using a hand-held calculator. This edition also continues the use of the effective interest method in the body of the chapter with coverage of the straight-line method illustrated in the appendix to the chapter.

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

Chapter 10 uses the example of the rapid growth of **Alphabet** (formerly **Google Inc.**) to explore four additional issues related to consolidated financial statements: the consolidated statement of cash flows, consolidation following an interim acquisition, consolidated tax considerations, and consolidated earnings per share. We have revised the chapter to clarify some of the illustrative examples and update the call-out boxes.

Chapter 11 focuses on foreign currency transactions, financial instruments, and the effects that changes in exchange rates can have on reported results. We provide real-world examples of the topics discussed in the chapter, including the introductory vignette about **Microsoft**. We have revised this chapter to clarify the illustrations and update the call-out boxes.

Chapter 12 resumes the discussion of international accounting by exploring **McDonald's** global empire and how differences in accounting standards across countries and jurisdictions can cause significant difficulties for multinational firms. We have revised the chapter to clarify the narrative and illustrations.

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

issues. We have also updated for recent changes in the tax law.

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

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

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

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

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

Chapter 19 introduces accounting for not-for-profit entities using the example of **United Way Worldwide**, the largest charitable organization in the United States. We present the accounting and financial reporting principles used by both governmental and nongovernmental colleges and

universities, health care providers, voluntary health and welfare organizations, and other not-for-profit organizations such as professional and fraternal associations. We have made revisions to better explain some topics that students have found to be most difficult.

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



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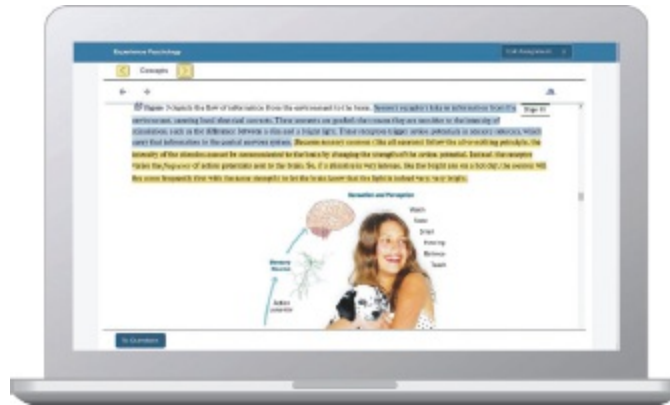
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Brief Table of Contents

PREFACE **vii**

- 1.** Intercorporate Acquisitions and Investments in Other Entities 1
- 2.** Reporting Intercorporate Investments and Consolidation of Wholly Owned Subsidiaries with No Differential 45
- 3.** The Reporting Entity and the Consolidation of Less-Than-Wholly-Owned Subsidiaries with No Differential 94
- 4.** Consolidation of Wholly Owned Subsidiaries Acquired at More Than Book Value 134
- 5.** Consolidation of Less-Than-Wholly-Owned Subsidiaries Acquired at More Than Book Value 183
- 6.** Intercompany Inventory Transactions 229
- 7.** Intercompany Transfers of Services and Noncurrent Assets 291
- 8.** Intercompany Indebtedness 367
- 9.** Consolidation Ownership Issues 447

10.	Additional Consolidation Reporting Issues	498
11.	Multinational Accounting: Foreign Currency Transactions and Financial Instruments	543
12.	Multinational Accounting: Issues in Financial Reporting and Translation of Foreign Entity Statements	616
13.	Segment and Interim Reporting	677
14.	SEC Reporting	724
15.	Partnerships: Formation, Operation, and Changes in Membership	752
16.	Partnerships: Liquidation	805
17.	Governmental Entities: Introduction and General Fund Accounting	843
18.	Governmental Entities: Special Funds and Governmentwide Financial Statements	901
19.	Not-for-Profit Entities	967
20.	Corporations in Financial Difficulty	1037

INDEX 1071



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Table of Contents

ABOUT THE AUTHORS **v**

PREFACE **vii**

Chapter 1

Intercorporate Acquisitions and Investments in other Entities **1**

T-Mobile's Merger with Sprint 1

An Introduction to Complex Business Structures 2

Enterprise Expansion 2

Business Objectives 2

Frequency of Business Combinations 3

Ethical Considerations 4

Business Expansion and Forms of Organizational Structure 5

Internal Expansion: Creating a Business Entity 5

External Expansion: Business Combinations 6

Organizational Structure and Financial Reporting 7

The Development of Accounting for Business Combinations 8

Accounting for Internal Expansion: Creating Business Entities 8

Accounting for External Expansion: Business Combinations 10

<i>Legal Forms of Business Combinations</i>	10
<i>Methods of Effecting Business Combinations</i>	11
<i>Valuation of Business Entities</i>	12
Acquisition Accounting	14
<i>Fair Value Measurements</i>	14
<i>Applying the Acquisition Method</i>	14
<i>Goodwill</i>	14
<i>Combination Effected through the Acquisition of Net Assets</i>	15
<i>Combination Effected through Acquisition of Stock</i>	19
<i>Financial Reporting Subsequent to a Business Combination</i>	20
Additional Considerations in Accounting for Business Combinations	21
<i>Uncertainty in Business Combinations</i>	21
<i>In-Process Research and Development</i>	22
<i>Noncontrolling Equity Held Prior to Combination</i>	22
Summary of Key Concepts	23
Key Terms	24
Questions	24
Cases	24
Exercises	26
Problems	36

Chapter 2

Reporting Intercorporate Investments and Consolidation of Wholly Owned Subsidiaries with No Differential 45

<i>Berkshire Hathaway's Many Investments</i>	45
<i>Accounting for Investments in Common Stock</i>	47
<i>Securities Carried at Fair Value</i>	49
<i>Accounting Procedures for Securities Carried at Fair Value</i>	49
<i>Changes in the Number of Shares Held</i>	50
The Equity Method	50
<i>Use of the Equity Method</i>	50
<i>Investor's Equity in the Investee</i>	51
<i>Recognition of Income</i>	51

<i>Recognition of Dividends</i>	52
<i>Carrying Amount of the Investment and Investment Income under the Equity Method</i>	52
<i>Changing to the Equity Method at an Interim Date</i>	52
<i>Acquisition at Interim Date</i>	53
<i>Changes in the Number of Shares Held</i>	53
Investments Carried at Fair Value and Investments Accounted for Using the Equity Method	54
Overview of the Consolidation Process	55
Consolidation Procedures for Wholly Owned Subsidiaries That Are Created or Purchased at Book Value	56
Consolidation Worksheets	56
<i>Worksheet Format</i>	56
<i>Nature of Consolidation Entries</i>	58
Consolidated Balance Sheet with Wholly Owned Subsidiary	58
<i>100 Percent Ownership Acquired at Book Value</i>	58
Consolidation Subsequent to Acquisition	63
<i>Consolidated Net Income</i>	63
<i>Consolidated Retained Earnings</i>	64
Consolidated Financial Statements—100 Percent Ownership, Created or Acquired at Book Value	65
<i>Initial Year of Ownership</i>	65
<i>Second and Subsequent Years of Ownership</i>	69
<i>Consolidated Net Income and Retained Earnings</i>	72
Summary of Key Concepts	72
Key Terms	73
APPENDIX 2A	
Additional Considerations Relating to the Equity Method	73
APPENDIX 2B	
Consolidation When Parent Companies Choose to Carry at Cost Investments That Are to Be Consolidated	76

Questions	79
Cases	80
Exercises	82
Problems	88

Chapter 3

The Reporting Entity and the Consolidation of Less-Than-Wholly-Owned Subsidiaries with No Differential 94

The Coca-Cola Company	94
The Usefulness of Consolidated Financial Statements	95
Limitations of Consolidated Financial Statements	96
Subsidiary Financial Statements	96
Consolidated Financial Statements: Concepts and Standards	97
<i>Traditional View of Control</i>	97
<i>Indirect Control</i>	97
<i>Ability to Exercise Control</i>	98
<i>Differences in Fiscal Periods</i>	98
<i>Changing Concept of the Reporting Entity</i>	98
Noncontrolling Interest	99
<i>Computation and Presentation of Noncontrolling Interest</i>	99
The Effect of a Noncontrolling Interest	100
<i>Consolidated Net Income</i>	100
<i>Consolidated Retained Earnings</i>	101
<i>Worksheet Format</i>	102
Consolidated Balance Sheet with a Less-Than-Wholly-Owned Subsidiary	103
<i>80 Percent Ownership Acquired at Book Value</i>	103
Consolidation Subsequent to Acquisition—80 Percent Ownership Acquired at Book Value	106
<i>Initial Year of Ownership</i>	107
<i>Second and Subsequent Years of Ownership</i>	109
Combined Financial Statements	112

Special-Purpose and Variable Interest Entities 113

Variable Interest Entities 113

Summary of Key Concepts 116

Key Terms 116

APPENDIX 3A

Consolidation of Variable Interest Entities 116

Questions 118

Cases 118

Exercises 119

Problems 126

Chapter 4

Consolidation of Wholly Owned Subsidiaries Acquired at More Than Book Value 134

How Much Work Does It Really Take to Consolidate? Ask the People Who Do It at Disney 134

Dealing with the Differential 135

The Difference between Acquisition Price and Underlying Book Value 136

Consolidation Procedures for Wholly Owned Subsidiaries Acquired at More Than Book Value 139

Treatment of a Positive Differential 142

Illustration of Treatment of a Complex Differential 144

100 Percent Ownership Acquired at Less Than Fair Value of Net Assets 147

Illustration of Treatment of Bargain Purchase 147

Consolidated Financial Statements—100 Percent Ownership Acquired at More Than Book Value 149

Initial Year of Ownership 149

Second Year of Ownership 154

Intercompany Receivables and Payables 157

Push-Down Accounting 157

Summary of Key Concepts 158

Key Terms 158

APPENDIX 4A

Push-Down Accounting Illustrated 159

Questions 161

Cases 162

Exercises 163

Problems 174

Chapter 5

Consolidation of Less-Than-Wholly-Owned Subsidiaries Acquired at More Than Book Value 183

Walmart Acquires a Controlling Interest in Massmart 183

A Noncontrolling Interest in Conjunction with a Differential 184

Consolidated Balance Sheet with Majority-Owned Subsidiary 184

Consolidated Financial Statements with a Majority-Owned Subsidiary
187

Initial Year of Ownership 187

Second Year of Ownership 191

Discontinuance of Consolidation 194

Treatment of Other Comprehensive Income 197

Modification of the Consolidation Worksheet 197

Adjusting Entry Recorded by Subsidiary 197

Adjusting Entry Recorded by Parent Company 198

Consolidation Worksheet—Second Year Following Combination 198

Consolidation Procedures 198

Consolidation Worksheet—Comprehensive Income in Subsequent Years 201

Summary of Key Concepts 201

Key Terms 202

APPENDIX 5A

Additional Consolidation Details 202

Questions	204
Cases	204
Exercises	206
Problems	214

Chapter 6

Intercompany Inventory Transactions 229

Inventory Transfers at Samsung Electronics	229
--------------------------------------------	-----

Overview of the Consolidated Entity and Intercompany Transactions	230
-------------------------------------------------------------------	-----

<i>Elimination of Intercompany Transfers</i>	231
----------------------------------------------	-----

<i>Elimination of Unrealized Profits and Losses</i>	231
-----------------------------------------------------	-----

Inventory Transactions	232
------------------------	-----

<i>Worksheet Consolidation Entries</i>	232
----------------------------------------	-----

<i>Transfers at Cost</i>	232
--------------------------	-----

<i>Transfers at a Profit or Loss</i>	232
--------------------------------------	-----

<i>Calculating Unrealized Profit or Loss</i>	233
----------------------------------------------	-----

<i>Deferring Unrealized Profit or Loss on the Parent's Books</i>	236
------------------------------------------------------------------	-----

<i>Deferring Unrealized Profit or Loss in the Consolidation</i>	237
-----------------------------------------------------------------	-----

<i>Why Adjust the Parent's Books and Make Worksheet Entries?</i>	239
------------------------------------------------------------------	-----

Downstream Inventory Sale	239
---------------------------	-----

<i>Year 1</i>	239
---------------	-----

<i>Year 2</i>	245
---------------	-----

Upstream Inventory Sale	249
-------------------------	-----

Additional Considerations	256
---------------------------	-----

<i>Sale from One Subsidiary to Another</i>	256
--------------------------------------------	-----

<i>Sales and Purchases before Affiliation</i>	256
-----------------------------------------------	-----

Summary of Key Concepts	257
-------------------------	-----

Key Terms	257
-----------	-----

APPENDIX 6A

Intercompany Inventory Transactions—Modified Equity Method and Cost Method 257

Questions 266

Cases 267

Exercises 268

Problems 276

Chapter 7

Intercompany Transfers of Services and Noncurrent Assets **291**

Micron's Intercompany Fixed Asset Sale 291

Intercompany Transfers of Services 292

Intercompany Long-Term Asset Transfers 293

Intercompany Land Transfers 294

Overview of the Profit Consolidation Process 294

Assignment of Unrealized Profit Consolidation 296

Downstream Land Sale—Comprehensive Three-Year Example 298

Year 1—Downstream Land Sale 298

Year 2—Subsidiary Holds Land 304

Year 3—Land Sold to Nonaffiliated Party 306

Upstream Sale of Land (Year of Sale) 310

Intercompany Transfers of Depreciable Assets 315

Downstream Sale 315

Change in Estimated Life of Asset upon Transfer 324

Upstream Sale 324

Asset Transfers before Year-End 333

Intercompany Transfers of Amortizable Assets 335

Summary of Key Concepts 335

Key Terms 335

APPENDIX 7A

Intercompany Noncurrent Asset Transactions—Modified Equity Method and Cost Method 335

Questions	344
Cases	345
Exercises	347
Problems	354

Chapter 8

Intercompany Indebtedness 367

Caesars Entertainment Corporation's Debt Transfers	367
Consolidation Overview	368
Bond Sale Directly to an Affiliate	369
<i>Transfer at Par Value</i>	369
<i>Transfer at a Discount or Premium</i>	370
Bonds of Affiliate Purchased from a Nonaffiliate	373
<i>Purchase at Book Value</i>	373
<i>Purchase at an Amount Less Than Book Value</i>	374
<i>Purchase at an Amount Higher Than Book Value</i>	387
Summary of Key Concepts	390
Key Terms	390

APPENDIX 8A

Intercompany Indebtedness—Fully Adjusted Equity Method Using Straight-Line Interest Amortization 390

APPENDIX 8B

Intercompany Indebtedness—Modified Equity Method and Cost Method 406

Questions	413
Cases	414
Exercises	415
Problems	423

Chapter 9

Consolidation Ownership Issues 447

Berkshire Hathaway's Varied Investments 447

Subsidiary Preferred Stock Outstanding 448

Consolidation with Subsidiary Preferred Stock Outstanding 448

Subsidiary Preferred Stock Held by Parent 451

Subsidiary Preferred Stock with Special Provisions 452

page xxvi

Illustration of Subsidiary Preferred Stock with Special Features 453

Changes in Parent Company Ownership 455

Parent's Purchase of Additional Shares from Nonaffiliate 456

Parent's Sale of Subsidiary Shares to Nonaffiliate 458

Subsidiary's Sale of Additional Shares to Nonaffiliate 460

Subsidiary's Sale of Additional Shares to Parent 463

Subsidiary's Purchase of Shares from Nonaffiliate 465

Subsidiary's Purchase of Shares from Parent 467

Complex Ownership Structures 469

Multilevel Ownership and Control 469

Reciprocal or Mutual Ownership 473

Subsidiary Stock Dividends 477

Illustration of Subsidiary Stock Dividends 478

Impact on Subsequent Periods 479

Summary of Key Concepts 480

Key Terms 481

Questions 481

Cases 482

Exercises 483

Problems 490

Chapter 10

Additional Consolidation Reporting Issues 498

Advanced Consolidation Issues at Alphabet	498
Consolidated Statement of Cash Flows	499
<i>Preparation of a Consolidated Cash Flow Statement</i>	499
<i>Consolidated Cash Flow Statement Illustrated</i>	499
<i>Consolidated Cash Flow Statement—Direct Method</i>	501
Consolidation Following an Interim Acquisition	503
<i>Parent Company Entries</i>	504
<i>Consolidation Worksheet</i>	505
Consolidation Income Tax Issues	507
<i>Allocating the Basis of Assets Acquired in a Business Combination</i>	507
<i>Tax Allocation Procedures When Separate Tax Returns Are Filed</i>	512
<i>Tax Effects of Unrealized Intercompany Profit Eliminations</i>	514
Consolidated Earnings per Share	518
<i>Computation of Diluted Consolidated Earnings per Share</i>	519
<i>Computation of Consolidated Earnings per Share Illustrated</i>	520
Summary of Key Concepts	522
Key Terms	522
Questions	522
Cases	523
Exercises	525
Problems	531

Chapter 11

Multinational Accounting: Foreign Currency Transactions and Financial Instruments **543**

Microsoft's Multinational Business	543
Doing Business in a Global Market	544
The Accounting Issues	545
Foreign Currency Exchange Rates	545
<i>The Determination of Exchange Rates</i>	546
<i>Direct versus Indirect Exchange Rates</i>	546
<i>Changes in Exchange Rates</i>	548

<i>Spot Rates versus Current Rates</i>	551
<i>Forward Exchange Rates</i>	551
Foreign Currency Transactions	551
<i>Foreign Currency Import and Export Transactions</i>	553
Managing International Currency Risk with Foreign Currency Forward Exchange Financial Instruments	557
<i>Derivatives Designated as Hedges</i>	557
<i>Forward Exchange Contracts</i>	561
<i>Case 1: Managing an Exposed Foreign Currency Net Asset or Liability Position: Not a Designated Hedging Instrument</i>	562
<i>Case 2: Hedging an Unrecognized Foreign Currency Firm Commitment: A Foreign Currency Fair Value Hedge</i>	568
<i>Case 3: Hedging a Forecasted Foreign Currency Transaction: A Foreign Currency Cash Flow Hedge</i>	572
<i>Case 4: Speculation in Foreign Currency Markets</i>	575
<i>Foreign Exchange Matrix</i>	577
Additional Considerations	577
<i>A Note on Measuring Hedge Effectiveness</i>	577
<i>Interperiod Tax Allocation for Foreign Currency Gains (Losses)</i>	578
<i>Hedges of a Net Investment in a Foreign Entity</i>	578
Summary of Key Concepts	578
Key Terms	579
APPENDIX 11A	
Illustration of Valuing Forward Exchange Contracts with Recognition for the Time Value of Money	579
APPENDIX 11B	
Use of Other Financial Instruments by Multinational Companies	582
Questions	594
Cases	594
Exercises	596
Problems	607

Chapter 12

Multinational Accounting: Issues in Financial Reporting and Translation of Foreign Entity Statements 616

MCDonald's—The World's Fast Food Favorite	616
Convergence of Accounting Principles	617
Accounting for Differences in Currencies and Exchange Rates	619
<i>Currency Definitions</i>	619
Determination of the Functional Currency	619
<i>Functional Currency Designation in Highly Inflationary Economies</i>	621
Translation versus Remeasurement of Foreign Financial Statements	622
Translation of Functional Currency Statements into the Reporting Currency of the U.S. Company	624
<i>Financial Statement Presentation of Translation Adjustment</i>	625
<i>Illustration of Translation and Consolidation of a Foreign Subsidiary</i>	626
<i>Noncontrolling Interest of a Foreign Subsidiary</i>	635
Remeasurement of the Books of Record into the Functional Currency	637
<i>Statement Presentation of Remeasurement Gain or Loss</i>	639
<i>Illustration of Remeasurement of a Foreign Subsidiary</i>	639
<i>Proof of Remeasurement Exchange Gain</i>	641
<i>Remeasurement Case: Subsequent Consolidation Worksheet</i>	642
<i>Summary of Translation versus Remeasurement</i>	645
Additional Considerations in Accounting for Foreign Operations and Entities	645
Foreign Investments and Unconsolidated Subsidiaries	646
<i>Liquidation of a Foreign Investment</i>	646
Hedge of a Net Investment in a Foreign Subsidiary	646
Disclosure Requirements	648
<i>Statement of Cash Flows</i>	648
<i>Lower-of-Cost-or-Market Inventory Valuation under Remeasurement</i>	648
<i>Intercompany Transactions</i>	649
<i>Income Taxes</i>	650
<i>Translation When a Third Currency Is the Functional Currency</i>	651

Summary of Key Concepts	651
Key Terms	651
Questions	652
Cases	652
Exercises	657
Problems	666

Chapter 13

Segment and Interim Reporting 677

Segment Reporting at Walmart	677
Reporting for Segments	678
Segment Reporting Accounting Issues	678
<i>International Financial Reporting Standards for Operating Segments</i>	678
Information about Operating Segments	679
<i>Defining Reportable Segments</i>	679
<i>Comprehensive Disclosure Test</i>	685
<i>Reporting Segment Information</i>	686
Enterprisewide Disclosures	687
<i>Information about Products and Services</i>	687
<i>Information about Geographic Areas</i>	688
<i>Information about Major Customers</i>	689
Interim Financial Reporting	689
The Format of the Quarterly Financial Report	689
Accounting Issues	690
<i>Accounting Pronouncements on Interim Reporting</i>	690
<i>International Financial Reporting Standards for Interim Reporting</i>	691
Reporting Standards for Interim Income Statements	691
<i>Revenue</i>	691
<i>Cost of Goods Sold and Inventory</i>	692
<i>All Other Costs and Expenses</i>	695
<i>Accounting for Income Taxes in Interim Periods</i>	697
<i>Disposal of a Component of the Entity or Unusual, Infrequently Occurring, and Contingent Items</i>	701

Accounting Changes in Interim Periods	701
<i>Change in an Accounting Principle (Retrospective Application)</i>	701
<i>Change in an Accounting Estimate (Current and Prospective Application)</i>	702
<i>Changes in Depreciation, Amortization, or Depletion</i>	702
<i>Change in a Reporting Entity (Retrospective Application)</i>	702
<i>International Financial Reporting Standards for Accounting Changes</i>	703
Summary of Key Concepts	703
Key Terms	703
Questions	703
Cases	704
Exercises	708
Problems	717

Chapter 14

SEC Reporting 724

The Genesis of Securities Regulation	724
International Harmonization of Accounting Standards for Public Offerings	725

Securities and Exchange Commission	726
<i>Organizational Structure of the Commission</i>	726
<i>Laws Administered by the SEC</i>	727
<i>The Regulatory Structure</i>	727
Issuing Securities: The Registration Process	729
<i>The Registration Statement</i>	731
<i>SEC Review and Public Offering</i>	731
<i>Accountants' Legal Liability in the Registration Process</i>	732
Periodic Reporting Requirements	732
<i>Accountants' Legal Liability in Periodic Reporting</i>	735
Electronic Data Gathering, Analysis, and Retrieval (EDGAR) System	735

Foreign Corrupt Practices Act of 1977	735
Sarbanes-Oxley Act of 2002	736
<i>Title I: Public Company Accounting Oversight Board</i>	736
<i>Title II: Auditor Independence</i>	737
<i>Title III: Corporate Responsibility</i>	737
<i>Title IV: Enhanced Financial Disclosures</i>	737
<i>Title V: Analyst Conflicts of Interest</i>	738
<i>Title VI: Commission Resources and Authority</i>	738
<i>Title VII: Studies and Reports</i>	738
<i>Title VIII: Corporate and Criminal Fraud Accountability</i>	738
<i>Title IX: White-Collar Crime Penalty Enhancements</i>	738
<i>Title X: Sense of Congress Regarding Corporate Tax Returns</i>	738
<i>Title XI: Corporate Fraud and Accountability</i>	738
Dodd-Frank Wall Street Reform and Consumer Protection Act	739
Jumpstart Our Business Startups (JOBS) Act	739
Disclosure Requirements	740
<i>Management Discussion and Analysis</i>	740
<i>Pro Forma Disclosures</i>	741
Summary of Key Concepts	741
Key Terms	742
Questions	742
Cases	743
Exercises	746

Chapter 15

Partnerships: Formation, Operation, and Changes in Membership 752

The Evolution of PricewaterhouseCoopers (PwC)	752
The Nature of the Partnership Entity	753
<i>Legal Regulation of Partnerships</i>	753
<i>Definition of a Partnership</i>	754
<i>Formation of a Partnership</i>	754
<i>Other Major Characteristics of Partnerships</i>	754

<i>Accounting and Financial Reporting Requirements for Partnerships</i>	757
<i>International Financial Reporting Standards for Small and Medium-Size Entities and Joint Ventures</i>	757
Accounting for the Formation of a Partnership	758
<i>Illustration of Accounting for Partnership Formation</i>	758
Accounting for the Operations of a Partnership	759
<i>Partners' Accounts</i>	760
Allocating Profit or Loss to Partners	761
<i>Illustrations of Profit Allocation</i>	762
<i>Multiple Profit Allocation Bases</i>	765
<i>Special Profit Allocation Methods</i>	766
Partnership Financial Statements	766
Changes in Membership	766
<i>General Concepts to Account for a Change in Membership in the Partnership</i>	767
<i>New Partner Purchases a Partnership Interest Directly from an Existing Partner</i>	768
<i>New Partner Invests in the Partnership</i>	771
<i>Determining a New Partner's Investment Cost</i>	783
<i>Disassociation of a Partner from the Partnership</i>	784
Summary of Key Concepts	786
Key Terms	786
APPENDIX 15A	
Tax Aspects of a Partnership	787
APPENDIX 15B	
Joint Ventures	788
Questions	789
Cases	790
Exercises	792
Problems	798
Chapter 16	
Partnerships: Liquidation	805
The Demise of Laventhol & Horwath	805

Overview of Partnership Liquidations	806	
<i>Disassociation, Dissolution, Winding-Up, and Liquidation of a Partnership</i>		806
Lump-Sum Liquidations	808	
<i>Realization of Assets</i>	808	
<i>Liquidation Expenses</i>	808	
<i>Illustration of a Lump-Sum Liquidation</i>	808	
Installment Liquidations	813	
<i>Illustration of Installment Liquidation Using Schedules of Safe Payments</i>		814
<i>Cash Distribution Plan</i>	817	
Additional Considerations	820	
<i>Incorporation of a Partnership</i>	820	
Summary of Key Concepts	821	
Key Terms	822	

APPENDIX 16A

Partners' Personal Financial Statements	822	
Questions	825	
Cases	826	
Exercises	827	
Problems	837	

Chapter 17

Governmental Entities: Introduction and General Fund Accounting 843

Accounting for the Bustling City of San Diego	843	
Differences between Governmental and Private Sector Accounting		844
History of Governmental Accounting	845	
Major Concepts of Governmental Accounting	846	
<i>Elements of Financial Statements</i>	846	
<i>Expendability of Resources versus Capital Maintenance Objectives</i>		847

<i>Definitions and Types of Funds</i>	847	
Financial Reporting of Governmental Entities		850
<i>Fund-Based Financial Statements: Governmental Funds</i>	851	
Measurement Focus and Basis of Accounting (MFBA)		853
<i>Basis of Accounting—Governmental Funds</i>	854	
<i>Basis of Accounting—Proprietary Funds</i>	857	
<i>Basis of Accounting—Fiduciary Funds</i>	857	
Budgetary Aspects of Governmental Operations		858
<i>Recording the Operating Budget</i>	858	
Accounting for Expenditures		859
<i>The Expenditure Process</i>	859	
<i>Classification of Expenditure Transactions and Accounts</i>	861	
<i>Outstanding Encumbrances at the End of the Fiscal Period</i>	862	
<i>Expenditures for Inventory</i>	865	
<i>Accounting for Fixed Assets</i>	867	
<i>Long-Term Debt and Capital Leases</i>	868	
<i>Investments</i>	869	
Interfund Activities		869
<i>Interfund Loans</i>	869	
<i>Interfund Services Provided and Used</i>	870	
<i>Interfund Transfers</i>	871	
<i>Interfund Reimbursements</i>	871	
Overview of Accounting and Financial Reporting for the General Fund		872
Comprehensive Illustration of Accounting for the General Fund		872
<i>Adoption of the Budget</i>	872	
<i>Property Tax Levy and Collection</i>	874	
<i>Other Revenue</i>	875	
<i>Expenditures</i>	876	
<i>Acquisition of Capital Asset</i>	876	
<i>Interfund Activities</i>	877	
<i>Adjusting Entries</i>	877	
<i>Closing Entries</i>	878	
<i>General Fund Financial Statement Information</i>	879	
Summary of Key Concepts		882
Key Terms		882

Questions	883
Cases	883
Exercises	885
Problems	893

Chapter 18

Governmental Entities: Special Funds and Governmentwide Financial Statements 901

Governmental Accounting in Maryland	901
Summary of Governmental Fund Types	902
Governmental Funds Worksheets	903
Special Revenue Funds	907
Capital Projects Funds	907
<i>Illustration of Transactions</i>	908
<i>Financial Statement Information for the Capital Projects Fund</i>	910
Debt Service Funds	910
<i>Illustration of Transactions</i>	911
<i>Financial Statement Information for the Debt Service Fund</i>	913
Permanent Funds	914
<i>Illustration of Transactions</i>	914
Governmental Funds Financial Statements	915
Enterprise Funds	918
<i>Illustration of Transactions</i>	918
<i>Financial Statements for the Proprietary Funds</i>	921
Internal Service Funds	924
<i>Illustration of Transactions</i>	924
<i>Financial Statements for Internal Service Funds</i>	926
Trust Funds	926
<i>Illustration of Private-Purpose Trust Fund</i>	927
Agency Funds	928
<i>Illustration of Transactions in an Agency Fund</i>	928
The Government Reporting Model	929

<i>Four Major Issues</i>	929
<i>Government Financial Reports</i>	931
<i>Governmentwide Financial Statements</i>	932
<i>Reconciliation Schedules</i>	936
<i>Budgetary Comparison Schedule</i>	937
<i>Management's Discussion and Analysis</i>	938
<i>Notes to the Governmentwide Financial Statements</i>	938
<i>Other Financial Report Items</i>	939
<i>Interim Reporting</i>	939
<i>Auditing Governmental Entities</i>	940
Additional Considerations	940
<i>Special-Purpose Governmental Entities</i>	940
Summary of Key Concepts	941
Key Terms	941

APPENDIX 18A

Other Governmental Entities—Public School Systems and the Federal Government 941

Questions	943
Cases	944
Exercises	945
Problems	957

Chapter 19

Not-for-Profit Entities 967

United Way Worldwide	967
Financial Reporting for Private, Not-for-Profit Entities	968
<i>Additional Standards for Not-for-Profit Entities</i>	970
Colleges and Universities	972
<i>Special Conventions of Revenue and Expenditure Recognition</i>	972
<i>Board-Designated Funds</i>	973

<i>Public Colleges and Universities</i>	973
<i>Private Colleges and Universities</i>	973
Health Care Providers	976
<i>Hospital Accounting</i>	977
<i>Financial Statements for a Not-for-Profit Hospital</i>	980
<i>Comprehensive Illustration of Hospital Accounting and Financial Reporting</i>	984
<i>Summary of Hospital Accounting and Financial Reporting</i>	995
Voluntary Health and Welfare Organizations	995
<i>Accounting for a VHWO</i>	995
<i>Financial Statements for a VHWO</i>	996
<i>Summary of Accounting and Financial Reporting for VHWOs</i>	1004
Other Not-for-Profit Entities	1006
<i>Accounting for an ONPO</i>	1006
<i>Financial Statements of an ONPO</i>	1006
<i>Summary of Accounting and Financial Reporting for an ONPO</i>	1008
Summary of Key Concepts	1009
Key Terms	1010
Questions	1010
Cases	1011
Exercises	1014
Problems	1024

Chapter 20

Corporations in Financial Difficulty **1037**

GM in Financial Distress 1037

Courses of Action 1039

Nonjudicial Actions 1039

Judicial Actions 1040

Chapter 11 Reorganizations 1041

Fresh Start Accounting 1043

Plan of Reorganization 1044

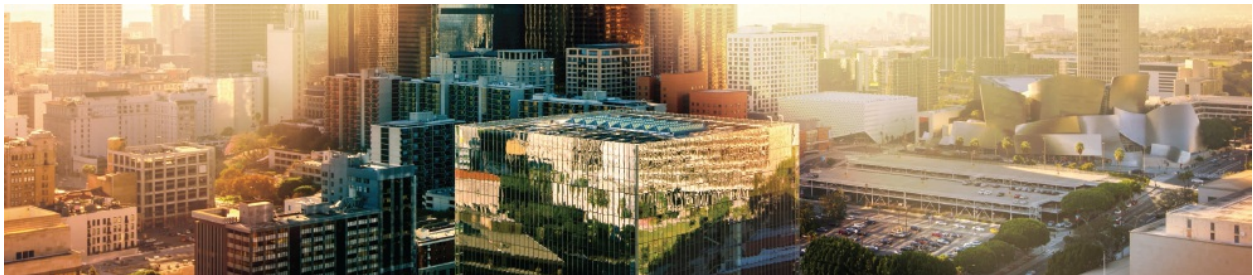
Illustration of a Reorganization 1044

Chapter 7 Liquidations 1052

Classes of Creditors	1052
<i>Secured Creditors</i>	1052
<i>Creditors with Priority</i>	1052
<i>General Unsecured Creditors</i>	1054
<i>Statement of Affairs</i>	1054
Additional Considerations	1055
<i>Trustee Accounting and Reporting</i>	1055
Summary of Key Concepts	1060
Key Terms	1061
Questions	1061
Cases	1061
Exercises	1063
Problems	1066

INDEX **1071**

1 Intercorporate Acquisitions and Investments in Other Entities



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Multicorporate Entities

Business Combinations

Consolidation Concepts and Procedures

Intercompany Transfers

Additional Consolidation Issues

Multinational Entities

Reporting Requirements

Partnerships

Governmental and Not-for-Profit
Entities

Corporations in Financial
Difficulty

T-MOBILE'S MERGER WITH SPRINT

Over the past several decades, but especially in recent years, the business world has witnessed many corporate acquisitions and combinations, often involving some of the world's largest and best-known companies. Some of these combinations have captured public attention because of the personalities involved, the daring strategies employed, and the huge sums of money exchanged in these "deals." On April 1, 2020, T-Mobile U.S. and the Sprint Corporation completed a long-awaited merger in which T-Mobile acquired Sprint in a stock-for-stock transaction valued at roughly \$37 billion. This was a major merger, combining the third- and fourth-largest wireless service providers to form the second-largest wireless carrier in the United States.

Prior to the merger, Sprint was the fourth-largest mobile network operator in the United States., tracing its origins to the Brown Telephone Company, founded in 1899. Over its long history, Sprint grew and expanded through several mergers and acquisitions of its own, including the merger with Nextel Communications in 2005. At the time of the merger, T-Mobile was the-third largest mobile carrier in the United States. Its genesis goes back to the founding of VoiceStream Wireless as a subsidiary of Western Wireless Corporation in 1994. Western Wireless spun off VoiceStream Wireless Corporation in 1999, and it was subsequently purchased by Deutsche Telekom in 2001 and renamed T-Mobile USA, Inc.

Discussions and negotiations between T-Mobile and Sprint began in 2013 and continued on and off for several years amid concerns about the likelihood of regulatory approval before a merger agreement was reached in April of 2018. After this merger agreement was signed, the deal would not be final for nearly two years. Though the merger endured one of the longest regulatory

approval processes in history, the FCC Chairman Ajit Pai acknowledged his support for the merger, which would provide the scale the company would need to roll out a 5G nationwide network that would not be possible for either of the companies individually. Pai stated the merger would be critical to “close the digital divide by bringing robust 5G deep into rural areas.”¹

Mike Sievert, CEO and president of T-Mobile, took the helm of the merged company in April of 2020 amidst the COVID-19 pandemic. He stated, “During this extraordinary time, it has become abundantly clear how vital a strong and reliable network is to the world we live in. The New T-Mobile’s commitment to delivering a transformative broad and deep nationwide 5G network is more important and more needed than ever. ... T-Mobile has been changing wireless for good—and now we are going to do it on a whole new level!”²

The business world is complex and frequent business combinations will continue to increase the complexity of the business environment in the future. An understanding of the accounting treatment of mergers, acquisitions, and other intercorporate investments is an invaluable asset in our ever-

page 2
changing markets. This chapter introduces the key concepts associated with business combinations.

LEARNING OBJECTIVES

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

- LO 1-1** Understand and explain the reasons for and different methods of business expansion, the types of organizational structures, and the types of acquisitions.
- LO 1-2** Understand the development of standards related to acquisition accounting over time.
- LO 1-3** Make calculations and prepare journal entries for the creation of a business entity.
- LO 1-4** Understand and explain the differences between different forms of business combinations.
- LO 1-5** Make calculations and business combination journal entries in the presence of a differential, goodwill, or a bargain purchase element.
- LO 1-6** Understand additional considerations associated with business combinations.

AN INTRODUCTION TO COMPLEX

BUSINESS STRUCTURES

LO 1–1

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

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

Enterprise Expansion

Most business enterprises seek to expand over time in order to survive and maintain profitability. Both the owners and the managers of a business enterprise have an interest in helping their company to grow in size. Increased size often allows economies of scale in both production and distribution. By expanding into new markets or acquiring other companies

already in those markets, companies can develop new earning potential and those in cyclical industries can add greater stability to earnings through diversification. For example, in 1997, Boeing, a company very strong in commercial aviation, acquired McDonnell Douglas, a company weak in commercial aviation but very strong in military aviation and other defense and space applications. In the early 2000s when orders for commercial airliners plummeted following a precipitous decline in air travel, increased defense spending helped level out Boeing's earnings.

Business Objectives

Complex organizational structures often evolve to help achieve a business's objectives, such as increasing profitability or reducing risk. For example, many companies establish subsidiaries to conduct certain business activities. A **subsidiary** is a corporation that another corporation, referred to as a page 3 **parent company**, controls, usually through majority ownership of its common stock. Because a subsidiary is a separate legal entity, the parent's risk associated with the subsidiary's activities is limited. There are many reasons for creating or acquiring a subsidiary. For example, companies often transfer their receivables to subsidiaries or special-purpose entities that use the receivables as collateral for bonds issued to other entities (securitization). External parties may hold partial or complete ownership of those entities, allowing the transferring company (i.e., the parent that originally held the receivables) to share its risk associated with the receivables. In some situations, companies can realize tax benefits by conducting certain activities through a separate entity. Bank of America, for example, established a subsidiary to which it transferred bank-originated loans and was able to save \$418 million in quarterly taxes.³

Frequency of Business Combinations

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

conducted within the parent company. Other subsidiaries are acquired externally through business combinations.

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

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

The number of business combinations through the 1990s dwarfed previous merger booms, shattering all prior records for merger activity. This pace continued into the new century, with a record-setting \$3.3 trillion in deals closed in 2000.⁴ However, with the downturn in the economy in the early 2000s, the number of mergers declined significantly. Many companies put their expansion plans on hold, and a number of the mergers that did occur were aimed at survival.

Toward the middle of 2003, merger activity again increased and accelerated significantly through the middle of the decade. During one period of less than 100 hours in 2006, “around \$110 billion in acquisition deals were sealed worldwide in sectors ranging from natural gas, to copper, to mouthwash to steel, linking investors and industrialists from India, to Canada, to Luxembourg to the United States.”⁵



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

Period	Name	Facet
1893–1904	First Wave	Horizontal mergers
1919–1929	Second Wave	Vertical mergers
1955–1970	Third Wave	Diversified conglomerate mergers
1974–1989	Fourth Wave	Congeneric mergers; hostile takeovers; corporate raiding, LBOs
1993–2000	Fifth Wave	Cross-border mergers
2003–2008	Sixth Wave	Shareholder activism, private equity, LBOs
2011–Present	Seventh Wave	Global expansion

Sources: Martin Lipton, “Merger Waves in the 19th, 20th, and 21st Centuries, The Davies Lecture, York University, September 14, 2006;” Michael J. De La Merced and Jeffrey Cane, “Confident Deal Makers Pulled Out Checkbooks in 2010,” The New York Times, January 3, 2011; Anastasia, “A Historical Analysis of M&A Waves,” Cleverism.com, January 26, 2016.

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

Aside from private equity acquisitions, business combinations have been common in telecommunications, defense, banking and financial services, information technology, energy and natural resources, entertainment,

pharmaceuticals, and manufacturing. Some of the world's largest companies and best-known names have been involved in recent major acquisitions, such as Microsoft, Time Warner, Kraft, Procter & Gamble, Gillette, Citigroup, Bank of America, Whirlpool, Sprint, Verizon, Adobe Systems, Chrysler, BP, and ExxonMobil.

Ethical Considerations

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

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

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

convert borrowings into reported revenues. The FASB has since clarified the rules around the accounting for SPEs to avoid this issue (which is discussed in more detail in Chapter 3).

Accounting for mergers and acquisitions is also an area that can lend itself to manipulation. Arthur Levitt, former chairman of the SEC, referred to some of the accounting practices that have been used in accounting for mergers and acquisitions as “creative acquisition accounting” or “merger magic.” For example, an approach used by many companies in accounting for their acquisitions was to assign a large portion of the purchase price of an acquired company to its in-process research and development, immediately expensing the full amount and freeing financial reporting in future periods from the burden of those costs. The FASB has since eliminated this practice.

page 5

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

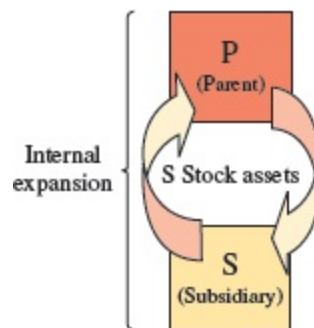
BUSINESS EXPANSION AND FORMS OF ORGANIZATIONAL STRUCTURE

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

to a change in organizational structure.

Internal Expansion: Creating a Business Entity

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



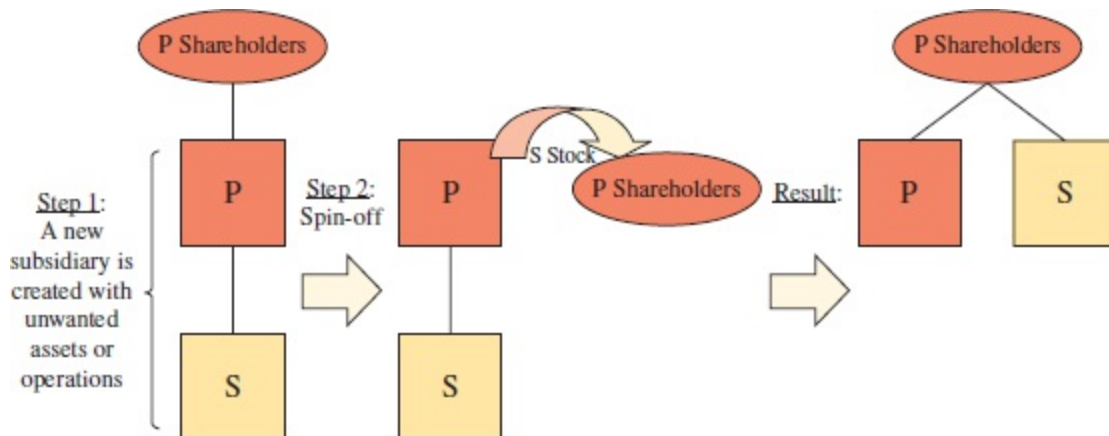
Companies may be motivated to establish new subsidiaries or other entities for a variety of reasons. Broadly diversified companies may place unrelated operations in separate subsidiaries to establish clear lines of control and facilitate the evaluation of operating results. In some cases, an entity that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

Companies also might establish new subsidiaries or other entities, not as a means of expansion, but as a means of disposing of a portion of their existing operations through outright sale or a transfer of ownership to existing shareholders or others. In some cases, companies have used this approach to

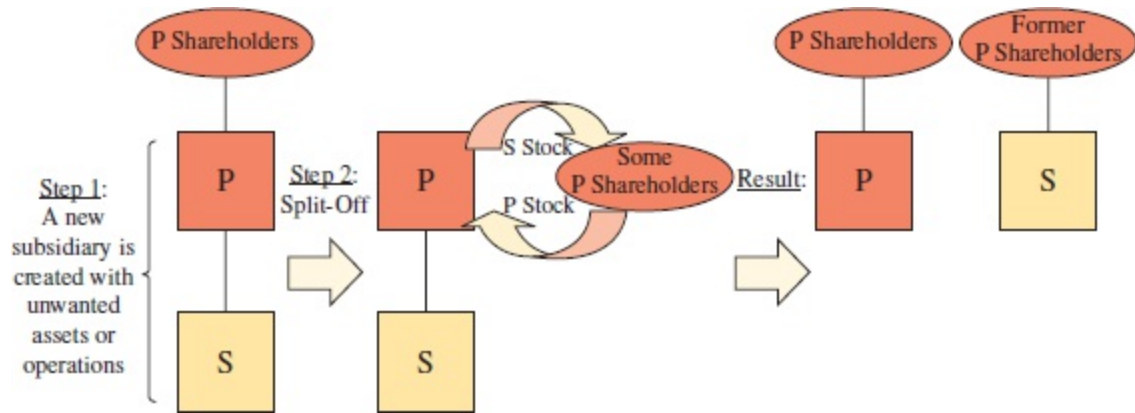
dispose of a segment of operations that no longer fits well with the overall mission of the company. In other cases, this approach has been used as a means of disposing of unprofitable operations or to gain page 6 regulatory or shareholder approval of a proposed merger with another company. A **spin-off** occurs when the ownership of a newly created or existing subsidiary is distributed to the parent's stockholders without the stockholders surrendering any of their stock in the parent company. Thus, the company divests itself of the subsidiary because it is owned by the company's shareholders after the spin-off.

FYI

In July of 2015, eBay spun off PayPal, which it had owned since 2002, to help both businesses take advantage of new growth opportunities.

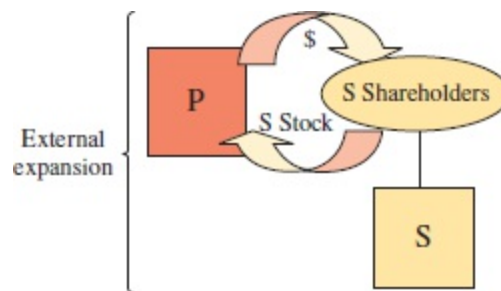


A **split-off** occurs when the subsidiary's shares are exchanged with *some* of P's shareholders for their P Company shares, thereby leading to a reduction in the parent company's outstanding shares. Thus, some of the P shareholders will keep their P shares while others will trade them for S shares, essentially dividing the original P shareholders. Although the two divestiture types are similar, the split-off could result in one set of the former parent shareholders exchanging their shares for those of the divested subsidiary.



External Expansion: Business Combinations

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



A business can be defined as an organization or enterprise engaged in providing goods or services to customers. However, a business doesn't

necessarily have to be a separate legal entity. A **business combination** occurs when “... an acquirer obtains control of one or more businesses.”⁶ The diagram on the preceding page illustrates a typical acquisition. The concept of **control** relates to the ability to direct policies and management. Traditionally, control over a company has been gained by acquiring a majority of the company’s common stock. However, the diversity of financial and operating arrangements employed in recent years also raises the possibility of gaining control with less than majority ownership or, in some cases, with no ownership at all through other contractual arrangements.

FYI

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

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

Organizational Structure and Financial Reporting

When companies expand or change organizational structure by acquiring other companies or through internal division, the new structure must be

examined to determine the appropriate financial reporting procedures. Several approaches are possible, depending on the circumstances:

- . **Merger** A merger is a business combination in which the acquired business's assets and liabilities are combined with those of the acquiring company. Thus, two companies are merged into a single entity. In essence, the acquiring company "swallows" the acquired business. When the two companies merge, one of them ceases to exist as a separate entity and the name of the acquiring company continues.
- . **Controlling ownership** A business combination in which the acquired company remains as a separate legal entity with a majority of its common stock owned by the purchasing company leads to a parent–subsidiary relationship. Accounting standards normally require that the financial statements of the parent and subsidiary be consolidated for general-purpose reporting so the companies appear as a single entity. The treatment is the same if the subsidiary is created rather than purchased. The treatment is also the same when the other entity is unincorporated and the investor company has control and majority ownership.⁷
- . **Noncontrolling ownership** The purchase of a less-than-majority interest in another corporation does not usually result in a business combination or controlling situation. A similar situation arises when a company creates another entity and holds less than a controlling position in it or purchases a less-than-controlling interest in an existing partnership. In its financial statements, the investor company reports its interest in the investee as an investment with the specific method of accounting (cost method, equity method, consolidation) dictated by the circumstances.
- . **Other beneficial interest** One company may have a beneficial interest in another entity even without a direct ownership interest. The beneficial interest may be defined by the agreement establishing the entity or by an operating or financing agreement. When the beneficial interest is page 8 based on contractual arrangements instead of majority stock ownership, the reporting rules may be complex and depend on the circumstances. In general, a company that has the ability to make decisions significantly affecting the results of another entity's activities or is expected to receive a majority of the other entity's profits and losses is considered to be that entity's **primary beneficiary**. Normally, that entity's

financial statements would be consolidated with those of the primary beneficiary.

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

THE DEVELOPMENT OF ACCOUNTING FOR BUSINESS COMBINATIONS

LO 1-2

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

For more than half a century, accounting for business combinations remained largely unchanged. Two methods of accounting for business combinations, *the purchase method* and the *pooling-of-interests method*, were acceptable during that time. However, major changes in accounting for business combinations have occurred over the past two decades. First, the FASB eliminated the pooling-of-interests method in 2001, leaving only a single method, purchase accounting. Then, in 2007, the FASB issued the revised standard (**ASC 805**) that replaced the purchase method with the *acquisition method*, which is now the only acceptable method of accounting for business combinations. The FASB continues to refine acquisition accounting, but it has not changed fundamentally since 2007.

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

The idea behind a pooling of interests that is, the *pooling-of-interests*

method, was that no change in ownership had actually occurred in the business combination, often a questionable premise. Based on this idea, the book values of the combining companies were carried forward to the combined company and assets and liabilities were not revalued to fair value. Managers often preferred pooling accounting because it did not result in asset write-ups or goodwill that might burden future earnings with additional depreciation or write-offs.

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

Acquisition accounting is consistent with the FASB's intention to move accounting in general more toward recognizing fair values. Under the **acquisition method**, the acquirer in a business combination, in effect, values the acquired company based on the fair value of the consideration given in the combination and the fair value of any noncontrolling interest not acquired by the acquirer. One way that the acquisition method differs from the old purchase method is that acquisition-related costs are expensed in the period incurred rather than capitalizing them in the purchase price.

ACCOUNTING FOR INTERNAL EXPANSION: CREATING BUSINESS ENTITIES

LO 1–3

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

Companies that choose to conduct a portion of their operations through separate business entities usually do so through corporate subsidiaries,

corporate joint ventures, or partnerships. The ongoing accounting and reporting for investments in corporate joint ventures and subsidiaries are discussed in Chapters 2 through 10. This section discusses the page 9 origination of these entities when the parent or investor creates them rather than purchases an interest in an existing corporation or partnership.



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

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

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

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

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

Padre records the transfer with the following entry:⁸

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

Equipment	250,000
-----------	---------

Record the creation of Sonny Company.

Sonny Company records the transfer of assets and the issuance of stock (at the book value of the assets) as follows:

(2)	Cash	70,000	
	Inventory	50,000	
	Land	75,000	
	Building	100,000	
	Equipment	250,000	
	Accumulated Depreciation, Building		20,000
	Accumulated Depreciation, Equipment		90,000
	Common Stock, \$2 par		200,000
	Additional Paid-In Capital		235,000

Record the receipt of assets and the issuance of \$2 par common stock.

ACCOUNTING FOR EXTERNAL EXPANSION: BUSINESS COMBINATIONS

LO 1–4

Understand and explain the differences between different forms of business combinations.



A business combination occurs when one party acquires control over one or more businesses. This usually involves two or more separate businesses being joined together under common control. The acquirer may obtain control by paying cash, transferring other assets, issuing debt, or issuing stock. In rare cases, the acquirer might obtain control by agreement or through other means without an exchange taking place. Business combinations can take one of several different forms and can be effected in different ways.

Legal Forms of Business Combinations

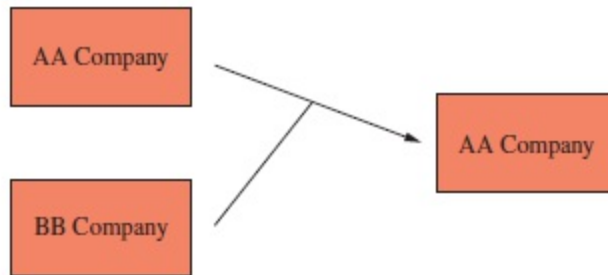
Figure 1–1 illustrates the three primary legal forms of business combinations. A **statutory merger** is a type of business combination in which only one of the combining companies survives and the other loses its separate identity. The acquired company's assets and liabilities are transferred to the acquiring company, and the acquired company is dissolved, or **liquidated**. The operations of the previously separate companies are carried on in a single legal entity following the merger. Unlike other forms of business combination that must be stock-only transactions to be tax free, a statutory merger allows the acquiring company to transfer stock and other assets to bail out dissenting shareholders.

A **statutory consolidation** is a business combination in which both combining companies are dissolved and the assets and liabilities of both companies are transferred to a newly created corporation. The operations of the previously separate companies are carried on in a single legal entity, and neither of the combining companies remains in existence after a statutory consolidation. In many situations, however, the resulting corporation is new in form only, and in substance it actually is one of the combining companies reincorporated with a new name.

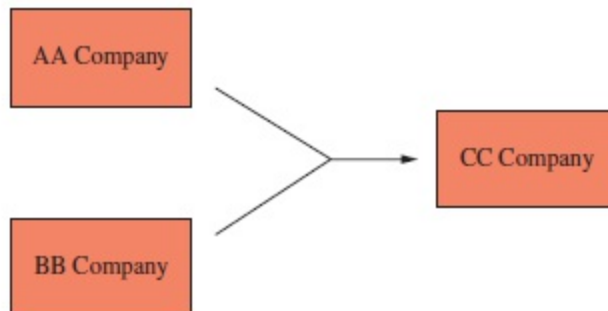
A **stock acquisition** occurs when one company acquires the voting shares of another company and the two companies continue to operate as separate,

but related, legal entities. Because neither of the combining companies is liquidated, the acquiring company accounts for its ownership interest in the other company as an investment. In a stock acquisition, the acquiring company need not acquire all the other company's stock to gain control. The relationship that is created in a stock acquisition is referred to as a **parent–subsidiary relationship**. A *parent company* is one that controls another company, referred to as a *subsidiary*, usually through majority ownership of common stock. For general-purpose financial reporting, a parent company and its subsidiaries present consolidated financial statements that appear largely as if the companies had actually merged into one.

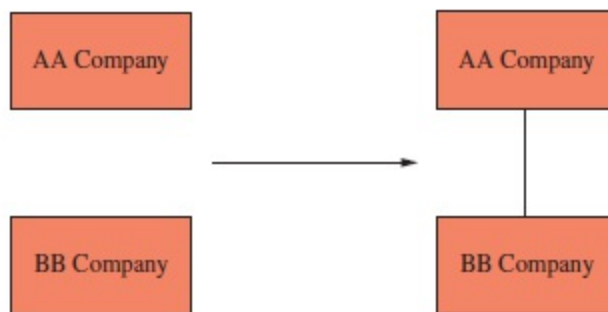
Sometimes a new corporation is created by two (or more) companies to become their common **holding company**, a special case of a stock acquisition. Assuming the shareholders of the two companies approve of the creation of the new holding company, they will exchange their shares in the existing companies for shares of the newly created holding company. The holding company becomes the parent company and the existing companies become the subsidiaries.



(a) Statutory merger



(b) Statutory consolidation



(c) Stock acquisition

The legal form of a business combination, the substance of the combination agreement, and the circumstances surrounding the combination all affect how the combination is recorded initially and the accounting and reporting procedures used subsequent to the combination.

Methods of Effecting Business Combinations

Business combinations can be characterized as either friendly or unfriendly. In a friendly combination, the managements of the companies involved come to an agreement on the terms of the combination and recommend approval by the stockholders. These combinations usually are effected in a single transaction involving an exchange of assets or voting shares. In an unfriendly combination, or “hostile takeover,” the managements of the companies involved are unable to agree on the terms of a combination, and the management of one of the companies makes a **tender offer** directly to the shareholders of the other company to buy their stock at a specified price. A tender offer invites the shareholders of the other company to “tender,” or exchange, their shares for securities or assets of the acquiring company. If sufficient shares are tendered, the acquiring company gains voting control of the other company and can install its own management by exercising its voting rights.

The specific procedures to be used in accounting for a business combination depend on whether the combination is effected through an acquisition of assets or an acquisition of stock.

Acquisition of Assets

Sometimes one company acquires another company’s assets through direct negotiations with its management. The agreement also may involve the acquiring company assuming the other company’s liabilities. Combinations of this sort normally take form (a) or form (b) in Figure 1–1. The selling company generally distributes to its stockholders the assets or securities received in the combination from the acquiring company and liquidates, leaving only the acquiring company as the surviving legal entity.

The acquiring company accounts for the combination by recording each asset acquired, each liability assumed, and the consideration given in exchange at fair value.

STOP & THINK 

Can you name the 10 largest and best-known North American merger and acquisition transactions? Most have all happened in your lifetime!

Rank	Year	Acquirer	Target	Transaction Value (in bil. USD)
1	2000	America Online Inc.	Time Warner	164.7
2	2013	Verizon Communications Inc.	Verizon Wireless Inc.	130.3
3	1999	Pfizer Inc.	Warner-Lambert Co.	89.6
4	2017	Walt Disney Co.	21st Century Fox Inc.	84.2
5	2016	AT&T Inc.	Time Warner Inc.	79.4
6	2019	Bristol-Myers Squibb Co.	Celgene Corp.	79.4
7	1998	Exxon Corp.	Mobil Corp.	78.9
8	2006	AT&T Inc.	BellSouth Corp.	72.7
9	1998	Travelers Group Inc.	Citicorp	72.6
10	2001	Comcast Corp.	AT&T Broadband & Internet Svcs	72.0

Source: Institute of Mergers, Acquisitions and Alliances.

Acquisition of Stock

A business combination effected through a stock acquisition does not necessarily have to involve the acquisition of all of a company's outstanding voting shares. For one company to gain control over another through stock ownership, a majority (i.e., more than 50 percent) of the outstanding voting shares usually is required unless other factors lead to the acquirer gaining control. The total of the shares of an acquired company not held by the controlling shareholder is called the **noncontrolling interest**. In the past, the noncontrolling interest was referred to as the **minority interest**.

In those cases when control of another company is acquired and both companies remain in existence as separate legal entities following the business combination, the investment in the stock of the acquired company is recorded on the books of the acquiring company as an asset.

Valuation of Business Entities

All parties involved in a business combination must believe they have an

opportunity to benefit before they will agree to participate. Determining whether a particular combination proposal is advantageous can be difficult. Both the value of a company's assets and its future earning potential are important in assessing the value of the company. Tax laws also influence investment decisions. For example, the existence of accumulated net operating losses that can be used under U.S. tax law to shelter future income from taxes increases the value of a potential acquiree.

Value of Individual Assets and Liabilities

The value of a company's individual assets and liabilities is usually determined by appraisal. For some items, the value may be determined with relative ease, such as investments that are traded actively in the securities markets or short-term receivables or payables. For other items, the appraisal may be much more subjective, such as the value of land located in an area where few recent sales have occurred. In addition, certain intangibles typically are not reported on the balance sheet. For example, the costs of developing new ideas, new products, and new production methods normally are expensed as research and development costs in the period incurred.

page 13

Current liabilities are often viewed as having fair values equal to their book values because they will be paid at face amount within a short time. Long-term liabilities, however, must be valued based on current interest rates if different from the effective rates at the issue dates of the liabilities. For example, if \$100,000 of 10-year, 6 percent bonds, paying interest annually, had been issued at par three years ago, and the current market rate of interest for the same type of security is 10 percent, the value of the liability currently is computed as follows:

Present value for 7 years at 10% of principal payment of \$100,000	\$51,316
Present value at 10% of 7 interest payments of \$6,000	<u>29,211</u>
Present value of bond	<u>\$80,527</u>

Although accurate assessments of the value of assets and liabilities may be difficult, they form an important part of the overall determination of the

value of an enterprise.

Value of Potential Earnings

In many cases, assets operated together as a group have a value that exceeds the sum of their individual values (i.e., there is unrecorded goodwill). This “going-concern value” makes it desirable to operate the assets as an ongoing entity rather than sell them individually. A company’s earning power as an ongoing enterprise is of obvious importance in valuing that company.

There are different approaches to measuring the value of a company’s future earnings. Sometimes companies are valued based on a multiple of their current earnings. For example, if Bargain Company reports earnings of \$35,000 for the current year, the company’s value based on a multiple of 10 times current earnings is \$350,000. The appropriate multiple to use is a matter of judgment and is based on factors such as the riskiness and variability of the earnings and the anticipated degree of growth.

Another method of valuing a company is to compute the present value of the anticipated future net cash flows generated by the company. This approach requires the assessment of the amount and timing of future cash flows and discounting them back to the present value at the discount rate determined to be appropriate for the type of enterprise. For example, if Bargain Company is expected to generate cash flows of \$35,000 for each of the next 25 years, the present value of the firm at a discount rate of 10 percent is \$317,696. Estimating the potential for future earnings requires numerous assumptions and estimates. Not surprisingly, the buyer and seller often have difficulty agreeing on the value of a company’s expected earnings.

Valuation of Consideration Exchanged

When one company acquires another, the acquiring company must place a value on the consideration given in the exchange. The acquiring company would encounter little difficulty in valuing the consideration in a cash acquisition, but valuation may be more difficult when the acquiring company gives securities, particularly new untraded securities or securities with unusual features. For example, General Motors completed an acquisition a number of years ago by issuing a new Series B common stock that paid dividends based on subsequent earnings of the acquired company rather than on the earnings of General Motors as a whole. Some companies have issued

non-interest-bearing bonds (zero coupon bonds), which have a fair value sufficiently below par value to compensate the holder for interest. Other companies have issued various types of convertible securities. Unless these securities, or others that are considered equivalent, are actively traded in the market, their value would have to be estimated. The approach generally followed is to use the value of some similar security with a determinable market value and adjust for the estimated value of the differences in the features of the two securities.

ACQUISITION ACCOUNTING

LO 1–5

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

Current standards require the use of the ***acquisition method*** of accounting for business combinations. Under the acquisition method, the acquirer recognizes all assets acquired and liabilities assumed in a business combination and measures them at their acquisition-date fair values. If less than 100 percent of the acquiree is acquired, the noncontrolling interest also is measured at its acquisition-date fair value. If the acquiring company already had an ownership interest in the acquiree, that investment is also measured at its acquisition-date fair value. Note that a business combination does not affect the amounts at which the other assets and liabilities of the acquirer are valued.



Fair Value Measurements

Because accounting for business combinations is now based on fair values, the measurement of fair values takes on added importance. The acquirer must value at fair value 1 the consideration it exchanges in a business combination, 2 each of the individual identifiable assets and liabilities acquired, 3 any noncontrolling interest in the acquiree, and 4 any interest already held in the acquiree. Normally, a business combination involves an arm's-length exchange between two unrelated parties. The value of the consideration given in the exchange is usually the best measure of the value received and, therefore, reflects the value of the acquirer's interest in the acquiree.⁹

Applying the Acquisition Method

For all business combinations, an acquirer must be identified, and that party is the one gaining control over the other. In addition, an acquisition date must be determined. That date is usually the closing date when the exchange transaction actually occurs. However, in rare cases control may be acquired on a different date or without an exchange, so the circumstances must be examined to determine precisely when the acquirer gains control.

Under the acquisition method, the full acquisition-date fair values of the individual assets acquired, both tangible and intangible, and liabilities assumed in a business combination are recognized by the consolidated entity. This is true regardless of the percentage ownership acquired by the controlling entity. If the acquirer acquires all of the assets and liabilities of the acquiree in a merger, these assets and liabilities are recorded on the books of the acquiring company at their acquisition-date fair values. If the acquiring company acquires partial ownership of the acquiree in a stock acquisition, the assets acquired and liabilities assumed appear at their full acquisition-date fair values in a consolidated balance sheet prepared immediately after the combination.

All costs of bringing about and consummating a business combination are charged to an acquisition expense as incurred. Examples of traceable costs include finders' fees, consulting fees, travel costs, and so on. The costs of issuing equity securities used to acquire the acquiree are treated in the same