

ADVANCED FINANCIAL ACCOUNTING

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Advanced Financial Accounting

A background image of the Chicago skyline, featuring the Willis Tower and other skyscrapers, with a river and bridges in the foreground. The image is framed by a thin black border. Yellow dots are scattered in the top and bottom corners of the page.

Advanced Financial Accounting

Twelfth Edition

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University of Georgia

David M. Cottrell
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Brigham Young University

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ADVANCED FINANCIAL ACCOUNTING, TWELFTH EDITION

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About the Authors



Courtesy Brigham Young University/Photo by Alison Fidel

Theodore E. Christensen

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

David M. Cottrell

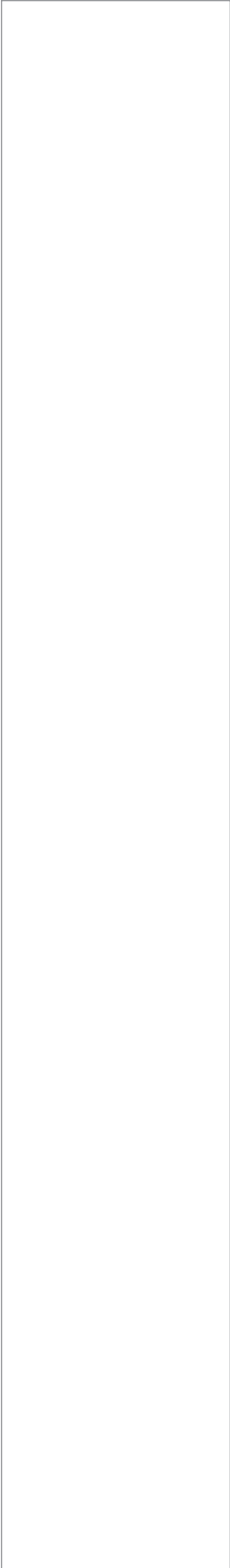
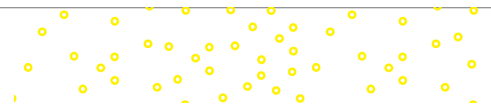
Professor Cottrell joined the faculty at Brigham Young University in 1991. Prior to coming to BYU, he spent five years at The Ohio State University where he earned his PhD. Before pursuing a career in academics, he worked as an auditor and consultant for the firm of Ernst & Young in its San Francisco 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.



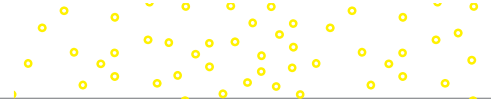
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Cassy JH Budd

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 introductory managerial accounting, undergraduate and graduate auditing, and partnership taxation. She is the recipient of numerous awards for teaching and student advisement, including the Dean Fairbanks Teaching and Learning Faculty Fellowship, Brigham Young University; School of Accountancy Advisor of the Year, Utah State University; State of Utah Campus



Compact Service-Learning Engaged Scholar Award, and the Joe Whitesides Scholar–Athlete Recognition Award from Utah State University. She has been active in serving on various committees of the American Accounting Association, including chairing the annual Conference on Teaching and Learning in Accounting. Professor Budd is currently serving as the President of the Teaching, Learning and Curriculum Section of the American Accounting Association.



Preface

OVERVIEW

The Twelfth 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.

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 Twelfth Edition covers the following topics:

Multicorporate Entities

Business Combinations

1. Intercorporate Acquisitions and Investments in Other Entities

Consolidation Concepts and Procedures

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

Intercompany Transfers

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

Additional Consolidation Issues

9. Consolidation Ownership Issues
10. Additional Consolidation Reporting Issues

Multinational Entities

Foreign Currency Transactions

11. Multinational Accounting: Foreign Currency Transactions and Financial Instruments

Translation of Foreign Statements

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

Reporting Requirements

Segment and Interim Reporting

13. Segment and Interim Reporting

SEC Reporting

14. SEC Reporting

Partnerships

Formation, Operation, Changes

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

Liquidation

16. Partnerships: Liquidation

Governmental and Not-for-Profit Entities

Governmental Entities

17. Governmental Entities: Introduction and General Fund Accounting

Special Funds

18. Governmental Entities: Special Funds and Governmentwide Financial Statements

Not-for-Profit

19. Not-for-Profit Entities

Corporations in Financial Difficulty

20. Corporations in Financial Difficulty

NEW FEATURES ADDED IN THE TWELFTH EDITION

New shading of consolidation worksheet entries. In the Twelfth Edition we have added full-color coordination of all consolidation items including (1) calculations, (2) consolidation journal entries, (3) T-accounts, and (4) worksheets. The full-color coordination 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 text users to quickly and clearly distinguish between Amortization amounts related to the current year and the current year Ending Balance for each item. The same colors help users to quickly 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 impact 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.” These color connections are illustrated in the calculations, consolidation entries, and T-accounts that follow.

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					Ending Balance
		256,000	Basic	40,000	28,700	
		58,700	Excess Value Reclassification		11,300	Amort. Reclassification
		0			0	

Users can continue the visual connections from the entries and the T-accounts all the way through the consolidation worksheet as shown in the following example. We have extended this shading not only to the worksheets but also to supporting schedules and calculation boxes so that numbers appearing in consolidation worksheet entries are uniformly shaded in all locations.

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		
			DR	CR	Consolidated
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

KEY FEATURES MAINTAINED IN THE TWELFTH 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 Twelfth Edition include:

- **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.
- **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 Twelfth 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 framework persist. The Twelfth Edition summarizes existing key differences between current U.S. GAAP and IFRS where applicable.
- **AdvancedStudyGuide.com.** See the section High Tech: The Twelfth Edition Adds Key Technology Resources to Benefit Both Students and Instructors for details.
- **The use of a continuous case for each major subject-matter area.** This textbook presents the complete story of a company, Peerless Products Corporation, from its beginning through its growth to a multinational consolidated entity and finally to its end. At each stage of the entity's development, including the acquisition of a subsidiary, Special Foods Inc., the text presents comprehensive examples and discussions of the accounting and financial reporting issues that accountants face. The discussions tied to the Peerless Products continuous case are easily identified by the company logos in the margin:



We use the comprehensive case of Peerless Products Corporation and its subsidiary, Special Foods Inc., throughout the for-profit chapters. For the governmental chapters, the Sol City case facilitates the development of governmental accounting and reporting concepts and procedures. Using a continuous case provides several benefits. First, students need 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 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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The statements contained in *Advanced Financial Accounting* Twelfth 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* Twelfth Edition and the teaching package make no claim of any specific AACSB qualification or evaluation, we have within *Advanced Financial Accounting* Twelfth Edition labeled selected questions according to the six general knowledge and skills areas.

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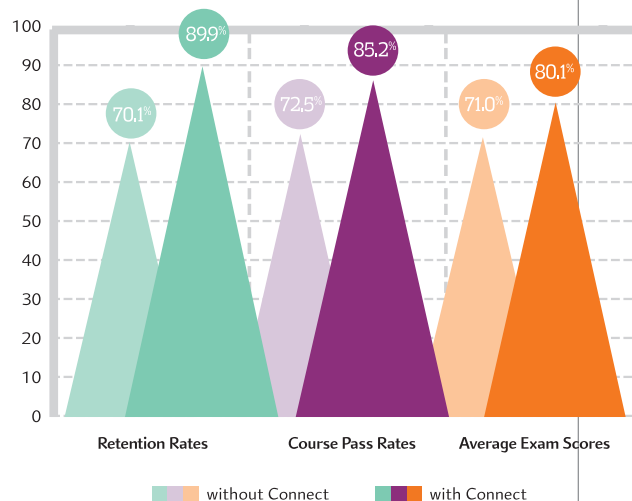
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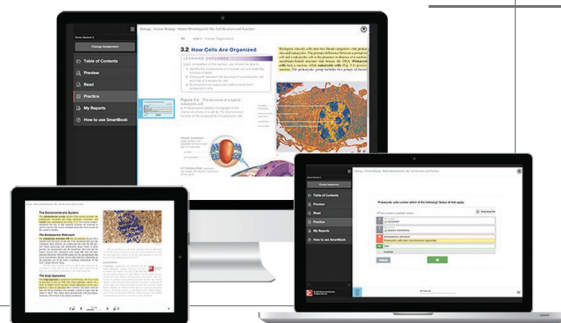


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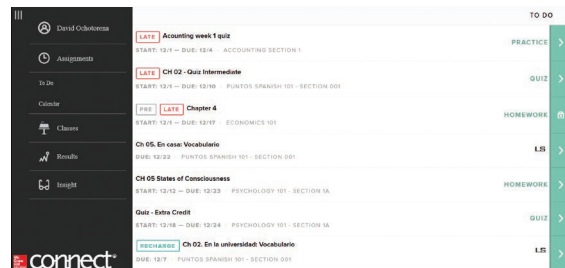


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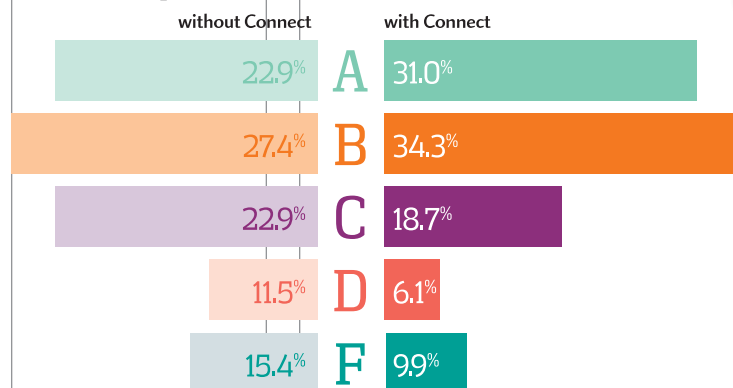
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The Questions

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

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

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CHAPTER-BY-CHAPTER CHANGES

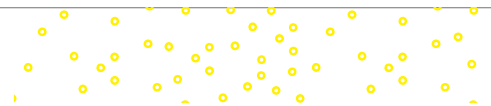
- **Chapter 1** emphasizes the importance of business acquisitions and combinations. The chapter has been significantly reorganized and updated based on feedback from textbook adopters to provide a clearer and more concise discussion of the accounting treatment of mergers, acquisitions, and other intercorporate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

Twelfth Edition, this chapter introduces a new method of shading our consolidation worksheet entries to make them easily distinguishable by the reader. We have updated this chapter to provide a more streamlined and understandable coverage of topics traditionally included in this chapter. Finally, we have updated the “callout boxes” that provide real-world examples of the topics discussed in the chapter, some of which provide additional information about **Berkshire Hathaway’s** investments discussed in the introductory vignette.

- **Chapter 3** explores how the basic consolidation process differs when a subsidiary is only partially owned. Moreover, it introduces the notion of special-purpose entities and accounting standards related to variable interest entities (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. We have streamlined and shortened this chapter based on feedback from adopters to provide a better flow for the material. In addition, we have updated the callout boxes to help students understand the intricacies associated with the consolidation of a partially owned subsidiary and dealing with variable interest entities.
- **Chapter 4** gives a behind-the-scenes look at the work that goes into the consolidation process based on **Disney Corporation** including its new 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. This chapter adds a detailed explanation of the new 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 58 percent of Samsung’s total revenues in 2016. 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 added a series of new callout boxes to draw students’ attention to the subtle complexities that our students have frequently struggled to understand.
- **Chapter 7** presents a real fixed asset transfer between two of **Micron’s** subsidiaries. This chapter explores the accounting for both depreciable and nondepreciable asset transfers among affiliated companies. Continuing the coverage of intercompany transfers from Chapter 6, Chapter 7 is one of the most difficult to teach for many adopters. Therefore, we have spent considerable time revising this chapter including 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). This edition 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 and expand some of the illustrative examples.
- **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 related to the use of forward contracts as hedging instruments and to update examples for recent changes in accounting standards.
- **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 based on feedback from adopters and students and to update some of the discussion for recent changes in accounting standards.
- **Chapter 13** examines segment reporting. We have made minor revisions to more clearly discuss the accounting standards for reporting an entity's operating components, foreign operations, and major customers and have updated the callout boxes illustrating how real companies, including **Walmart** from the introductory vignette, deal with segment reporting issues.
- **Chapter 14** reviews the complex role of the **Securities and Exchange Commission** to regulate trades of securities and to determine the type of financial disclosures that a publicly held company must make. We have made light revisions to update the coverage for recent laws and regulations.
- **Chapter 15** uses the example of **PricewaterhouseCoopers** to summarize the evolution of the original Big 8 accounting firms to today's Big 4 with an emphasis on partnerships. This chapter focuses on the formation and operation of partnerships, including accounting for the addition of new partners and the retirement of a present partner. We have made light revisions to the chapter to better explain partnership accounting.
- **Chapter 16** illustrates the dissolution of partnerships with the example of **Laventhol & Horwath**, the seventh-largest accounting firm in 1990. We have made light revisions to clarify some of the more difficult concepts related to partnership liquidation.
- **Chapter 17** introduces the topic of accounting for governmental entities. The chapter has two parts: the accounting and reporting requirements for state and local governmental units and a comprehensive illustration of accounting for a city's general fund. We have made light revisions to better explain some topics that students have found to be most difficult. Moreover, we have updated the callout boxes (most of which highlight specific examples related to the introductory vignette about **San Diego, California**) to clarify various topics.
- **Chapter 18** resumes the discussion of accounting for governmental entities by specifically examining special funds and governmentwide financial statements.



We have lightly revised the chapter topics that are often misunderstood by students and have updated the callout boxes (which highlight specific examples related to the introductory vignette about the state of **Maryland**). Moreover, we have added some additional details related to more recent GASB pronouncements that were not included in the last edition.

- **Chapter 19** introduces accounting for not-for-profit entities using the example of **United Way Worldwide**, the largest charitable organization in the United States. We present the accounting and financial reporting principles used by both governmental and nongovernmental colleges and universities, health care providers, voluntary health and welfare organizations, and other not-for-profit organizations such as professional and fraternal associations. We have updated the chapter extensively based on new standards related to the presentation of net assets for not-for-profit entities (ASU 2016-14, ASC 958-210).
- **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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This text includes the thoughts and contributions of many individuals, and we wish to express our sincere appreciation to them. First and foremost, we thank all the students in our advanced accounting classes from whom we have learned so much. In many respects, this text is an outcome of the learning experiences we have shared with our students. Second, we wish to thank the many outstanding teachers we have had in our own educational programs from whom we learned the joy of learning. We are indebted to our colleagues in advanced accounting for helping us reach our goal of writing the best possible advanced financial accounting text. We appreciate the many valuable comments and suggestions from the faculty who used recent editions of the text. Their comments and suggestions have contributed to making this text a more effective learning tool. We especially wish to thank Stacie Hughes of Athens State University, Lauren Materne and James Shinnors from the University of Michigan, Melissa Larson from Brigham Young University, and Sheldon Smith from Utah Valley University.

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*Theodore E. Christensen
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Intercorporate Acquisitions and Investments in Other Entities

MICROSOFT'S ACQUISITION OF LINKEDIN

In recent years, as well as during the past several decades, the business world has witnessed many corporate acquisitions and combinations, often involving some of the world's largest and best-known companies. Some of these combinations have captured public attention because of the personalities involved, the daring strategies employed, and the huge sums of money at stake. On June 13, 2016, Microsoft Corp. announced the acquisition of LinkedIn for \$26.2 billion. Although the software giant, Microsoft, has grown through acquisitions in the past, the LinkedIn acquisition represents the largest in Microsoft's history.

LinkedIn began as a startup Internet-based social media website for connecting business professionals in December of 2002. The company grew rapidly, reaching a million users by August of 2004. LinkedIn went public in 2011 in a well-publicized IPO. The company continued to grow through many acquisitions of its own until the agreement was reached in 2016 that it would be acquired by Microsoft.

LinkedIn's acquisition by Microsoft was the result of amicable negotiations between the two companies and the deal was unanimously approved by both boards. According to Microsoft's website, the agreement was reached with enthusiasm from both sides.

"The LinkedIn team has grown a fantastic business centered on connecting the world's professionals," Microsoft's CEO, Satya Nadella said. "Together we can accelerate the growth of LinkedIn, as well as Microsoft Office 365 and Dynamics as we seek to empower every person and organization on the planet."

"Just as we have changed the way the world connects to opportunity, this relationship with Microsoft, and the combination of their cloud and LinkedIn's network, now gives us a chance to also change the way the world works," LinkedIn's founder and CEO, Jeff Weiner, said. "For the last 13 years, we've been uniquely positioned to connect professionals to make them more productive and successful, and I'm looking forward to leading our team through the next chapter of our story."

Microsoft financed the all-cash deal by issuing new debt and the acquisition was completed in December of 2016.

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

LEARNING OBJECTIVES

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

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

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

- LO 1-3** Make calculations and prepare journal entries for the creation of a business entity.
- LO 1-4** Understand and explain the differences between different forms of business combinations.
- LO 1-5** Make calculations and business combination journal entries in the presence of a differential, goodwill, or a bargain purchase element.
- LO 1-6** Understand additional considerations associated with business combinations.

AN INTRODUCTION TO COMPLEX BUSINESS STRUCTURES

LO 1-1

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

The business environment in the United States is perhaps the most dynamic and vibrant in the world, characterized by rapid change and exceptional complexity. In this environment, regulators and standard setters such as the Securities and Exchange Commission (SEC), the Financial Accounting Standards Board (FASB), and the Public Company Accounting Oversight Board (PCAOB) are working to keep pace with a rapidly-changing world in order to ensure the continued usefulness of accounting reports so that they 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 become profitable. Both the owners and managers of a business enterprise have an interest in seeing a company grow in size. Increased size often allows economies of scale in both production and distribution. By expanding into new markets or acquiring other companies already in those markets, companies can develop new earning potential and those in cyclical industries can add greater stability to earnings through diversification. For example, in 1997, Boeing, a company very strong in commercial aviation, acquired McDonnell Douglas, a company weak in commercial aviation but very strong in military aviation and other defense and space applications. In the early 2000s when orders for commercial airliners plummeted following a precipitous decline in air travel, increased defense spending helped level out Boeing's earnings.

Business Objectives

Complex organizational structures often evolve to help achieve a business's objectives, such as increasing profitability or reducing risk. For example, many companies establish subsidiaries to conduct certain business activities. A **subsidiary** is a corporation that another corporation, referred to as a **parent company**, controls, usually through majority ownership of its common stock. Because a subsidiary is a separate legal entity, the parent's risk associated with the subsidiary's activities is limited. There are many reasons for creating or acquiring a subsidiary. For example, companies often transfer their receivables to subsidiaries or special-purpose entities that use the receivables as collateral for bonds issued to other entities (securitization). External parties may hold partial or complete ownership of those entities, allowing the transferring company (i.e., the parent that originally held the receivables) to share its risk associated with

the receivables. In some situations, companies can realize tax benefits by conducting certain activities through a separate entity. Bank of America, for example, established a subsidiary to which it transferred bank-originated loans and was able to save \$418 million in quarterly taxes.¹

Frequency of Business Combinations

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

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

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

The number of business combinations through the 1990s dwarfed previous merger booms, with all records for merger activity shattered. This pace continued into the new century, with a record-setting \$3.3 trillion in deals closed in 2000.² However, with the downturn in the economy in the early 2000s, the number of mergers declined significantly. Many companies put their expansion plans on hold, and a number of the mergers that did occur were aimed at survival.

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



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.

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

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

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

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.

The scandals and massive accounting failures at companies such as Enron, WorldCom, and Tyco—causing creditors, investors, employees, and others to suffer heavy losses—focused considerable attention on weaknesses in accounting and the accounting profession. In the past several years, Congress, the SEC, and the FASB have taken actions to strengthen the financial reporting process and to clarify the accounting rules relating

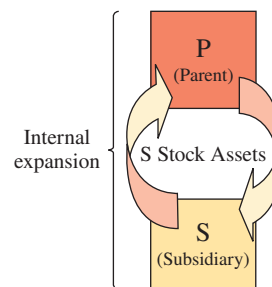
to special entities and to acquisitions. However, the frequency and size of business combinations, the complexity of accounting, and the potential impact on financial statements of the accounting methods employed mean that the issues surrounding the accounting for business combinations are still of critical importance.

BUSINESS EXPANSION AND FORMS OF ORGANIZATIONAL STRUCTURE

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

Internal Expansion: Creating a Business Entity

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



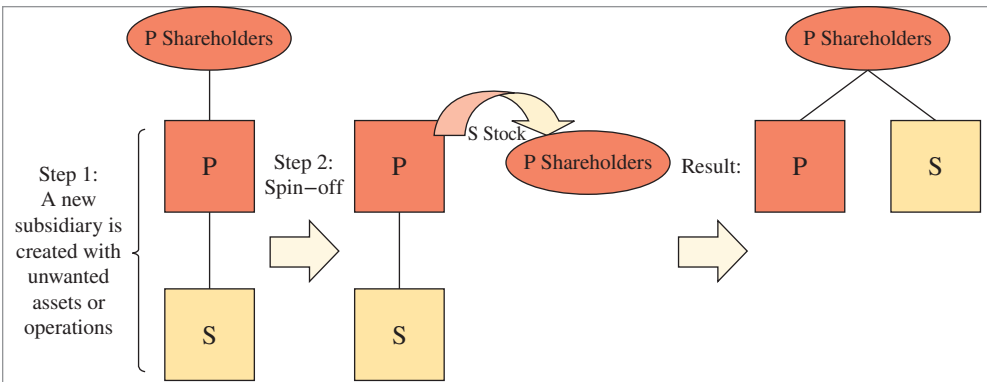
Companies may be motivated to establish new subsidiaries or other entities for a variety of reasons. Broadly diversified companies may place unrelated operations in separate subsidiaries to establish clear lines of control and facilitate the evaluation of operating results. In some cases, an entity that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

Companies also might establish new subsidiaries or other entities, not as a means of expansion, but as a means of disposing of a portion of their existing operations through outright sale or a transfer of ownership to existing shareholders or others. In some cases, companies have used this approach to dispose of a segment of operations that no longer fits well with the overall mission of the company. In other cases, this approach has been used as a means of disposing of unprofitable operations or to gain regulatory or shareholder approval of a proposed merger with another company. A *spin-off* occurs when the ownership of a newly created or existing subsidiary is distributed to the parent's stock-

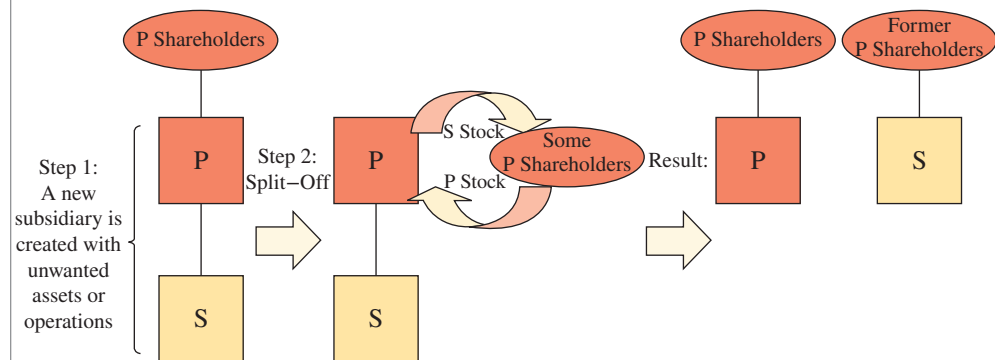
holders without the stockholders surrendering any of their stock in the parent company. Thus, the company divests itself of the subsidiary because it is owned by the company's shareholders after the spin-off.



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

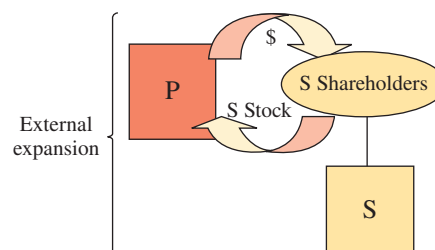


A *split-off* occurs when the subsidiary's shares are exchanged with *some* of P's shareholders for their P Company shares, thereby leading to a reduction in the parent company's outstanding shares. Thus, some of the P shareholders will keep their P shares while others will trade them for S shares, essentially 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 had to acquire an existing bank to obtain a charter in the state.





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.

A business can be defined as an organization or enterprise engaged in providing goods or services to customers. However, a business doesn’t necessarily have to be a separate legal entity. A **business combination** occurs when “. . . an acquirer obtains control of one or more businesses.”⁴ The diagram on the preceding page illustrates a typical acquisition. The concept of **control** relates to the ability to direct policies and management. Traditionally,

control over a company has been gained by acquiring a majority of the company’s common stock. However, the diversity of financial and operating arrangements employed in recent years also raises the possibility of gaining control with less than majority ownership or, in some cases, with no ownership at all through other contractual arrangements.

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

Organizational Structure and Financial Reporting

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

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

⁴ ASC 805-10-65-1

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

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

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

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

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

ACCOUNTING FOR INTERNAL EXPANSION: CREATING BUSINESS ENTITIES⁶

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

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



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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 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.

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	160,000
		<u>\$435,000</u>

Padre records the transfer with the following entry:⁷

(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.

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

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.



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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

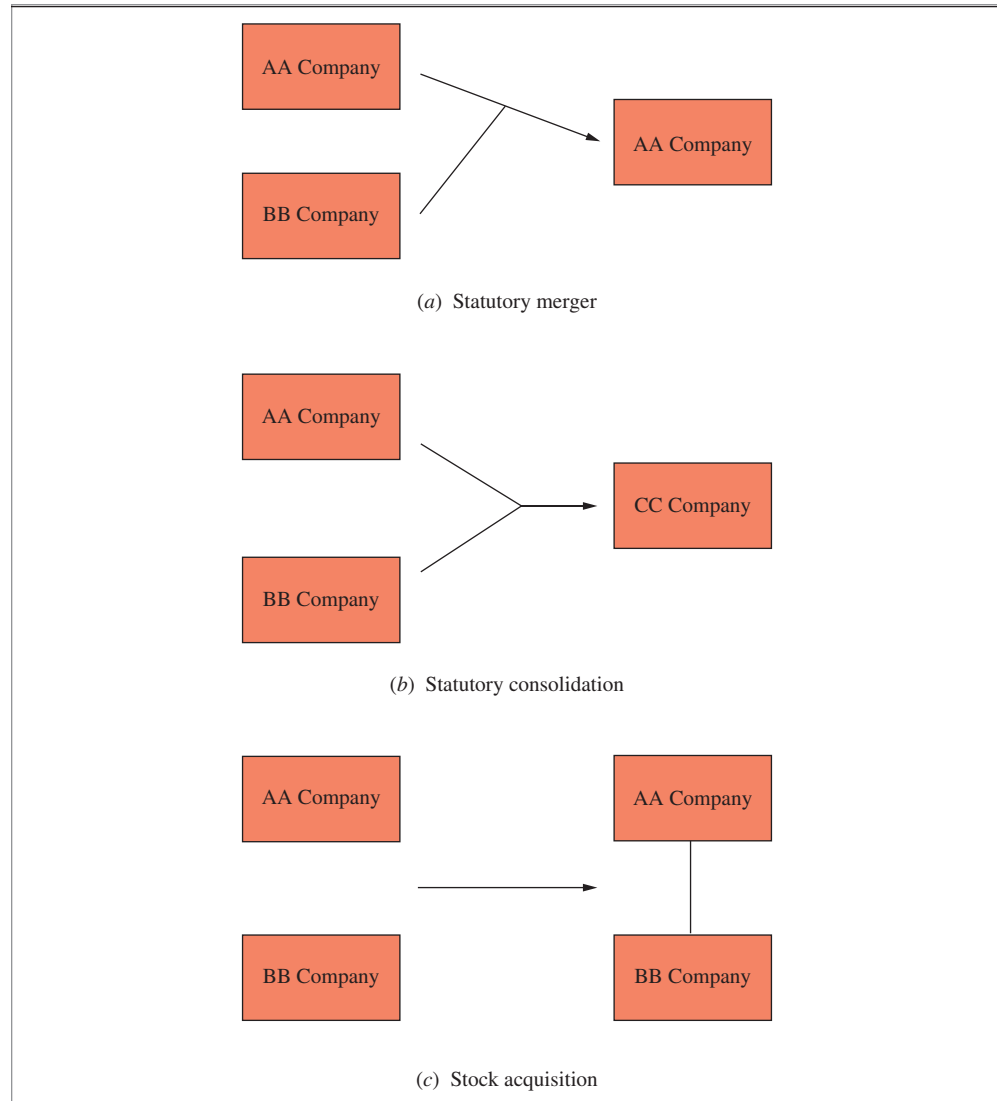
Figure 1–1 illustrates the three primary legal forms of business combinations. A **statutory merger** is a type of business combination in which only one of the combining companies survives and the other loses its separate identity. The acquired company's assets and liabilities are transferred to the 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.

FIGURE 1–1
Legal Forms of Business
Combinations



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? They've all happened in your lifetime!

Rank	Year	Acquirer	Target	Transaction Value (in bil. USD)
1	1999	Vodafone AirTouch PLC	Mannesmann AG	202.8
2	2000	America Online Inc.	Time Warner Inc.	164.8
3	2013	Verizon Communications Inc.	Verizon Wireless Inc.	130.3
4	2015	Anheuser-Busch	SABMiller PLC	101.1
5	2007	RFS Holdings	ABN-AMRO Holding	98.2
6	1999	Pfizer Inc.	Warner-Lambert Co.	89.2
7	2016	AT&T Inc.	Time Warner Inc.	85.4
8	1998	Exxon Corp.	Mobil Corp.	80.0
9	2006	AT&T Inc.	BellSouth Corp.	72.7
10	1998	Travelers Group Inc.	Citicorp	72.6

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.

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	29,211
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. Little difficulty is encountered when the acquiring company gives cash in an 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 being traded in the market, estimates of their value must be made. 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.



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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.⁸

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 manner as stock issues costs are normally treated, as a reduction in the paid-in capital associated with the securities.

Goodwill

Conceptually, *goodwill* as it relates to business combinations consists of all those intangible factors that allow a business to earn above-average profits. From an accounting perspective, the FASB has stated that *goodwill* "is an asset representing the future economic benefits arising from other assets acquired in a business combination that

⁸ However, the FASB decided in **ASC 805** to focus directly on the value of the consideration given rather than just using it to impute a fair value for the acquiree as a whole. In some cases, the value of the consideration given may be difficult to determine, or there may be no exchange, and valuation is better based on the value of the acquirer's interest in the acquiree or other valuation techniques. **ASC 820** provides a framework for applying fair value measurements in accounting.



Microsoft recorded roughly \$20 billion in goodwill when it acquired LinkedIn in 2016.

are not individually identified and separately recognized” (ASC 805-10-20). An asset is considered to be *identifiable*, and therefore must be separately recognized, if it is separable (can be separated from the business) or arises from a contractual or other right.

Under the acquisition method, an acquirer measures and recognizes goodwill from a business combination based on the difference between the total fair value of the acquired company and the fair value of its net identifiable assets. However, the FASB decided, for several reasons, not to focus directly on the total fair value of the acquiree, but rather on the components that provide an indication of that fair value.

The fair value of the consideration given is compared with the acquisition-date fair value of the acquiree’s net identifiable assets, and any excess is *goodwill*.

As an example of the computation of goodwill, assume that Pepper Company acquires all of the assets of Salt Company for \$400,000 when the fair value of Salt’s net identifiable assets is \$380,000. Goodwill is recognized for the \$20,000 difference between the total consideration given and the fair value of the net identifiable assets acquired. If, instead of an acquisition of assets, Pepper acquires 75 percent of the common stock of Salt for \$300,000, and the fair value of the noncontrolling interest is \$100,000, goodwill is computed as follows:

Fair value of consideration given by Pepper	\$300,000
+ Fair value of noncontrolling interest	<u>100,000</u>
Total fair value of Salt Company	\$400,000
– Fair value of net identifiable assets acquired	<u>(380,000)</u>
Goodwill	<u>\$ 20,000</u>

Note that the total amount of goodwill is not affected by whether 100 percent of the acquiree or less than that is acquired. However, the fair value of the noncontrolling interest does have an effect on the amount of goodwill recognized. In the example given, the fair values of the controlling and noncontrolling interests are proportional (each is valued at an amount equal to its proportionate ownership share of the total) and imply a total fair value of the acquired company of \$400,000. This is frequently the case and will always be assumed throughout the text unless indicated otherwise. However, that may not always be the case in practice. Situations might arise in a stock acquisition, for example, where the per-share value of the controlling interest is higher than that of the noncontrolling interest because of a premium associated with gaining control.

Combination Effected through the Acquisition of Net Assets

When one company acquires all the net assets of another in a business combination, the acquirer records on its books the individual assets acquired and liabilities assumed in the combination and the consideration given in exchange. Each identifiable asset and liability acquired is recorded by the acquirer at its acquisition-date fair value. The acquiring company records any excess of the fair value of the consideration exchanged over the fair value of the acquiree’s net identifiable assets as goodwill.

To illustrate the application of the acquisition method of accounting to a business combination effected through the acquisition of the acquiree’s net assets, assume that Point Corporation acquires all of the assets and assumes all of the liabilities of Sharp Company in a statutory merger by issuing 10,000 shares of \$10 par common stock to



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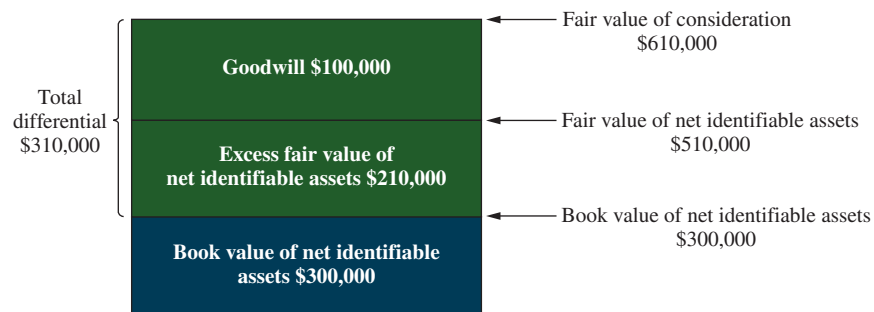
FIGURE 1-2

Sharp Company Balance Sheet Information, December 31, 20X0

Assets, Liabilities & Equities	Book Value	Fair Value
Cash & Receivables	\$45,000	\$ 45,000
Inventory	65,000	75,000
Land	40,000	70,000
Buildings & Equipment	400,000	350,000
Accumulated Depreciation	(150,000)	
Patent		80,000
Total Assets	<u>\$400,000</u>	<u>\$620,000</u>
Current Liabilities	\$100,000	110,000
Common Stock (\$5 par)	100,000	
Additional Paid-In Capital	50,000	
Retained Earnings	150,000	
Total Liabilities & Equities	<u>\$400,000</u>	
Fair Value of Net Assets		<u>\$510,000</u>

Sharp. The shares issued have a total market value of \$610,000. Point incurs legal and appraisal fees of \$40,000 in connection with the combination and stock issue costs of \$25,000. Figure 1-2 shows the book values and fair values of Sharp's individual assets and liabilities on the date of combination.

The relationships among the fair value of the consideration exchanged, the fair value of Sharp's net assets, and the book value of Sharp's net assets are illustrated in the following diagram:



The total difference at the acquisition date between the fair value of the consideration exchanged and the book value of the net identifiable assets acquired is referred to as the **differential**. In more complex situations, the differential is equal to the difference between (1) the acquisition-date fair value of the consideration transferred by the acquirer, plus the acquisition-date fair value of any equity interest in the acquiree previously held by the acquirer, plus the fair value of any noncontrolling interest in the acquiree and (2) the acquisition-date book values of the identifiable assets acquired and liabilities assumed.

In the Point/Sharp merger, the total differential of \$310,000 reflects the difference between the total fair value of the shares issued by Point and the carrying amount of Sharp's net assets reflected on its books at the date of combination. A portion of that difference (\$210,000) is attributable to the increased value of Sharp's net assets over book value. The remainder of the difference (\$100,000) is considered to be goodwill.

The \$40,000 of acquisition costs incurred by Point in carrying out the acquisition are expensed as incurred:

(3)	Acquisition Expense	40,000	
	Cash		40,000

Record costs related to acquisition of Sharp Company.

Portions of the \$25,000 of stock issue costs related to the shares issued to acquire Sharp may be incurred at various times. To facilitate accumulating these amounts before recording the combination, Point may record them in a separate temporary “suspense” account as incurred:

(4)	Deferred Stock Issue Costs	25,000	
	Cash		25,000

Record costs related to issuance of common stock.

On the date of combination, Point records the acquisition of Sharp with the following entry:

(5)	Cash and Receivables	45,000	
	Inventory	75,000	
	Land	70,000	
	Buildings and Equipment	350,000	
	Patent	80,000	
	Goodwill	100,000	
	Current Liabilities		110,000
	Common Stock		100,000
	Additional Paid-In Capital		485,000
	Deferred Stock Issue Costs		25,000

Record acquisition of Sharp Company.

Entry (5) records all of Sharp’s individual assets and liabilities, both tangible and intangible, on Point’s books at their fair values on the date of combination. The fair value of Sharp’s net assets recorded is \$510,000 (\$620,000 – \$110,000). The \$100,000 difference between the fair value of the shares given by Point (\$610,000) and the fair value of Sharp’s net assets is recorded as goodwill.

In recording the business combination, Sharp’s book values are not relevant to Point; only the fair values are recorded. Because a change in ownership has occurred, the basis of accounting used by the acquired company is not relevant to the acquirer. Consistent with this view, accumulated depreciation recorded by Sharp on its buildings and equipment is not relevant to Point and is not recorded. (Note that this is different from the way depreciable assets for an internally created subsidiary were handled previously.)

The stock issue costs are treated as a reduction in the proceeds received from the issuance of the stock. Thus, these costs are removed from the temporary account with a credit and decrease to Additional Paid-In Capital. Point records the \$610,000 of stock issued at its value minus the stock issue costs, or \$585,000. Of this amount, the \$100,000 par value is recorded in the Common Stock account and the remainder in Additional Paid-In Capital.

Entries Recorded by Acquired Company

On the date of the combination, Sharp records the following entry to recognize receipt of the Point shares and the transfer of all individual assets and liabilities to Point:

(6)	Investment in Point Stock	610,000	
	Current Liabilities	100,000	
	Accumulated Depreciation	150,000	
	Cash and Receivables		45,000
	Inventory		65,000
	Land		40,000
	Buildings and Equipment		400,000
	Gain on Sale of Net Assets		310,000

Record transfer of assets to Point Corporation.

Sharp recognizes the fair value of Point Corporation shares at the time of the exchange and records a gain of \$310,000. The distribution of Point shares to Sharp shareholders and the liquidation of Sharp are recorded on Sharp's books with the following entry:

(7)	Common Stock	100,000	
	Additional Paid-In Capital	50,000	
	Retained Earnings	150,000	
	Gain on Sale of Net Assets	310,000	
	Investment in Point Stock		610,000

Record distribution of Point Corporation stock.

Subsequent Accounting for Goodwill by Acquirer

The acquirer records goodwill arising in a merger as the difference between the fair value of the consideration exchanged and the fair value of the identifiable net assets acquired, as illustrated in entry (5). Once the acquirer records goodwill, it must be accounted for in accordance with **ASC 350**. Goodwill is carried forward at the originally recorded amount unless it is determined to be impaired. Goodwill must be reported as a separate line item in the balance sheet. A goodwill impairment loss that occurs subsequent to recording goodwill must be reported as a separate line item within income from continuing operations in the income statement unless the loss relates to discontinued operations, in which case the loss is reported within the discontinued operations section.

Goodwill must be tested for impairment at least annually, at the same time each year, and more frequently if events that are likely to impair the value of the goodwill occur. The process of testing goodwill for impairment was recently simplified by the FASB (ASU 2017-04). It requires the testing for goodwill impairment for each of the company's reporting units, where a reporting unit is an operating segment⁹ or a component of an operating segment that is a business for which management regularly reviews financial information from that component. When goodwill arises in a business combination, it must be assigned to individual reporting units. The goodwill is assigned to units that are expected to benefit from the combination, even if no other assets or liabilities of the acquired company are assigned to those units. To test for goodwill impairment, the fair value of the reporting unit is compared with its carrying value. If the fair value of the reporting unit exceeds its carrying value, the goodwill of that reporting unit is considered unimpaired. On the other hand, if the carrying value of the reporting unit exceeds its fair value, an impairment of the reporting unit's goodwill is recorded for the amount by which the carrying value exceeds the fair value. However, the loss on impairment cannot exceed the value of recorded goodwill for the reporting unit.¹⁰

⁹ An operating segment is defined in **ASC 280-10-50**. Whereas U.S. GAAP assigns goodwill to reporting units, IFRS assigns goodwill to cash-generating units (GCU).

¹⁰ ASU 2014-02 grants private companies the option of amortizing goodwill on a straightline basis over a period not to exceed 10 years.

As an example of goodwill impairment, assume that Reporting Unit A is assigned \$100,000 of goodwill arising from a recent business combination. The following assets and liabilities are assigned to Reporting Unit A:

Item	Carrying Amount
Cash and Receivables	\$ 50,000
Inventory	80,000
Equipment	120,000
Goodwill	100,000
Total Assets	\$350,000
Current Payables	(10,000)
Net Assets	<u>\$340,000</u>

By summing the carrying amounts of the assets and subtracting the carrying amount of the payables, the net carrying amount of the reporting unit, including the goodwill, is determined to be \$340,000. If the fair value of the reporting unit is estimated to be \$360,000 (or any number greater than the carrying amount), goodwill is not impaired. On the other hand, if the fair value of the reporting unit is estimated to be \$280,000, the \$60,000 difference (\$340,000 – \$280,000) represents Reporting Unit A's goodwill impairment loss and the goodwill's new carrying amount is \$40,000 (after recording the impairment). Note that the impairment loss cannot exceed the amount of goodwill assigned to the reporting unit. This goodwill impairment loss is combined with any impairment losses from other reporting units to determine the total goodwill impairment loss to be reported by the company as a whole. Goodwill is written down by the amount of the impairment loss. Once written down, goodwill may not be written up for subsequent recoveries.

Bargain Purchase¹¹

Occasionally, the fair value of the consideration given in a business combination, along with the fair value of any equity interest in the acquiree already held and the fair value of any noncontrolling interest in the acquiree, may be less than the fair value of the acquiree's net identifiable assets, resulting in a **bargain purchase**. This might occur, for example, with a forced sale.

When a bargain purchase occurs (rarely), the acquirer must take steps to ensure that all acquisition-date valuations are appropriate. If they are, the acquirer recognizes a gain at the date of acquisition for the excess of the amount of the net identifiable assets acquired and liabilities assumed as valued under **ASC 805**, usually at fair value, over the sum of the fair value of the consideration given in the exchange, the fair value of any equity interest in the acquiree held by the acquirer at the date of acquisition, and the fair value of any noncontrolling interest. Along with the amount of the gain, companies must disclose the operating segment where the gain is reported and the factors that led to the gain.

To illustrate accounting for a bargain purchase, assume that in the previous example of Point and Sharp, Point is able to acquire Sharp for \$500,000 cash even though the fair value of Sharp's net identifiable assets is



On September 22, 2008, at the climax of the global financial crisis, Barclays Bank PLC completed the bargain purchase acquisition of Lehman Brothers' North American businesses. Lehman Brothers was a former U.S.-based investment bank. Barclays is an international banking and financial services firm based in London. Barclays recorded a significant gain on bargain purchase at the time of this acquisition:

In 1000s of USD	
Net Assets Acquired	\$6,098 ^a
Cash Paid	1,541
Attributable Costs	75
Obligation to Be Settled in Shares	301
Less: Total Consideration	<u>1,917</u>
Gain on Bargain Purchase	<u>\$4,181</u>

^aSelected Information from Barclays Bank PLC Annual Report 2008 Note 40(a), translated to U.S.\$ using the GBPUSD Spot Rate 9/22/08 of 1.8483£/\$.

¹¹ See Chapter 4 for a more detailed discussion of this topic.



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estimated to be \$510,000. In this simple bargain-purchase case without an equity interest already held or a noncontrolling interest, the fair value of Sharp's net identifiable assets exceeds the consideration exchanged by Point, and, accordingly, a \$10,000 gain attributable to Point is recognized.

In accounting for the bargain purchase (for cash) on Point's books, the following entry replaces previous entry (5):

(8)	Cash and Receivables	45,000	
	Inventory	75,000	
	Land	70,000	
	Buildings and Equipment	350,000	
	Patent	80,000	
	Cash		500,000
	Current Liabilities		110,000
	Gain on Bargain Purchase of Sharp Company		10,000

Record acquisition of Sharp Company.

Combination Effected through Acquisition of Stock

Many business combinations are effected by acquiring the voting stock of another company rather than by acquiring its net assets. When a business combination is effected through a stock acquisition, the acquiree may lose its separate identity and be merged into the acquiring company or it may continue to operate as a separate company. If the acquired company is liquidated and its assets and liabilities are transferred to the acquirer, the dollar amounts recorded are identical to those in entry (5).

If the acquired company continues to exist, the acquirer records an investment in the common stock of the acquiree rather than its individual assets and liabilities. The acquirer records its investment in the acquiree's common stock at the total fair value of the consideration given in exchange. For example, if Point Corporation (a) exchanges 10,000 shares of its stock with a total market value of \$610,000 for all of Sharp Company's shares and (b) incurs merger costs of \$40,000 and stock issue costs of \$25,000, Point records the following entries upon receipt of the Sharp stock:

(9)	Acquisition Expense	40,000	
	Deferred Stock Issue Costs	25,000	
	Cash		65,000

Record merger and stock issue costs related to acquisition of Sharp Company.

(10)	Investment in Sharp Stock	610,000	
	Common Stock		100,000
	Additional Paid-In Capital		485,000
	Deferred Stock Issue Costs		25,000

Record acquisition of Sharp Company stock.

The details of the accounting and reporting procedures for intercorporate investments in common stock when the acquiree continues in existence are discussed in the next nine chapters.

Financial Reporting Subsequent to a Business Combination

Financial statements prepared subsequent to a business combination reflect the combined entity beginning on the date of combination going forward to the end of the fiscal period. When a combination occurs during a fiscal period, income earned by the acquiree prior to the combination is not reported in the income of the combined enterprise. If the combined company presents comparative financial statements that include statements for periods before the combination, those statements include only the activities and financial position of the acquiring company, not those of the combined entity or the acquiree.

To illustrate financial reporting subsequent to a business combination, assume the following information for Point Corporation and Sharp Company:

	20X0	20X1
Point Corporation:		
Separate Income (excluding any income from Sharp)	\$300,000	\$300,000
Shares Outstanding, December 31	30,000	40,000
Sharp Company:		
Net Income	\$ 60,000	\$ 60,000

Point Corporation acquires all of Sharp Company's stock at book value on January 1, 20X1, by issuing 10,000 shares of common stock. Subsequently, Point Corporation presents comparative financial statements for the years 20X0 and 20X1. The net income and earnings per share (EPS) that Point presents in its comparative financial statements for the two years are as follows:

20X0:	
Net Income	\$300,000
Earnings per Share (\$300,000/30,000 shares)	\$10.00
20X1:	
Net Income (\$300,000 + \$60,000)	\$360,000
Earnings per Share (\$360,000/40,000 shares)	\$9.00

If Point Corporation had acquired Sharp Company in the middle of 20X1 instead of at the beginning, Point would include only Sharp's earnings subsequent to acquisition in its 20X1 income statement. If Sharp earned \$25,000 in 20X1 before acquisition by Point and \$35,000 after the combination, Point would report total net income for 20X1 of \$335,000 (\$300,000 + \$35,000). Note that if the shares are issued in the middle of the year to effect the acquisition, the weighted-average shares used in the EPS calculation would change as well.

ADDITIONAL CONSIDERATIONS IN ACCOUNTING FOR BUSINESS COMBINATIONS

LO 1–6

Understand additional considerations associated with business combinations.

ASC 805 includes a number of requirements relating to specific items or aspects encountered in business combinations. A discussion of the more common situations follows.

Uncertainty in Business Combinations

Uncertainty affects much of accounting measurement but is especially prevalent in business combinations. Although uncertainty relates to many aspects of business combinations, three aspects of accounting for business combinations deserve particular attention: the measurement period, contingent consideration, and acquiree contingencies.

Measurement Period

One type of uncertainty in business combinations arises from numerous required fair value measurements. Because the acquirer may not have sufficient information available immediately to properly ascertain fair values, **ASC 805** allows for a period of time, called the *measurement period*, to acquire the necessary information. The measurement period ends once the acquirer obtains the necessary information about the facts as of the acquisition date, but may not exceed one year beyond the acquisition date.

Assets that have been provisionally recorded as of the acquisition date are retrospectively adjusted in value during the measurement period for new information that clarifies the acquisition-date value. Usually, the offsetting entry is to goodwill. Retrospective adjustments may not be made for changes in value that occur subsequent to the acquisition date, even when those changes occur during the measurement period.

As an illustration, assume that Sonny Company acquires land in a business combination and provisionally records the land at its estimated fair value of \$100,000. During the measurement period, Sonny receives a reliable appraisal that the land was worth \$110,000 at the acquisition date. Subsequently, during the same accounting period, a change in the zoning of a neighboring parcel of land reduces the value of the land acquired by Sonny to \$75,000. Sonny records the clarification of the acquisition-date fair value of the land and the subsequent impairment of value with the following entries:

(11)	Land	10,000	
	Goodwill		10,000
Adjust acquisition-date value of land acquired in business combination.			
(12)	Impairment Loss	35,000	
	Land		35,000
Recognize decline in value of land held.			

Contingent Consideration

Sometimes the consideration exchanged by the acquirer in a business combination is not fixed in amount, but rather is contingent on future events. For example, the acquiree and acquirer may enter into a *contingent-share agreement* whereby, in addition to an initial issuance of shares, the acquirer may agree to issue a certain number of additional shares for each percentage point by which the earnings number exceeds a set amount over the next five years. Thus, total consideration exchanged in the business combination is not known within the measurement period because the number of shares to be issued is dependent on future events.

ASC 805 requires contingent consideration in a business combination to be valued at fair value as of the acquisition date (and classified as either a liability or equity). The right to require the return of consideration given that it is dependent on future events is classified as an asset. Contingent consideration classified as an asset or liability is remeasured each period to fair value and the change is recognized in income.¹² Contingent consideration classified as equity is not remeasured.

Acquiree Contingencies

Certain contingencies may relate to an acquiree in a business combination, such as pending lawsuits or loan guarantees made by the acquiree. Certainly, the acquirer considers such contingencies when entering into an acquisition agreement, and the accounting must also consider such contingencies. Under **ASC 805**, the acquirer must recognize all contingencies that arise from contractual rights or obligations and other contingencies if it is probable that they meet the definition of an asset or liability at the acquisition date. The acquirer records these contingencies at acquisition-date fair value.

For all acquired contingencies, the acquirer should provide a description of each, disclose the amount recognized at the acquisition date, and describe the estimated range of possible undiscounted outcomes. Subsequently, the acquirer should disclose changes in the amounts recognized and in the range of possible outcomes. Note that the accounting for acquiree contingencies is no different from the accounting for any other contingency.

In-Process Research and Development

In normal operations, research and development costs are required to be expensed as incurred except under certain limited conditions. When a company acquires valuable ongoing research and development projects from an acquiree in a business combination,

¹² The treatment of contingent consideration under IFRS is slightly different. Although contingent consideration classified as an asset or liability will likely be a financial instrument measured at fair value with gains or losses recognized in profit or loss, if the asset or liability is not a financial instrument, it is accounted for in accordance with the standard provisions for that class of asset or liability (i.e., not necessarily at fair value).

a question arises as to whether these should be recorded as assets. The FASB concluded in **ASC 805** that these projects are assets and should be recorded at their acquisition-date fair values, even if they have no alternative use. These projects should be classified as having indefinite lives and, therefore, should not be amortized until completed and brought to market. They should be tested for impairment in accordance with current standards. Projects that are subsequently abandoned are written off when abandoned. Subsequent expenditures for the previously acquired research and development projects would normally be expensed as incurred.

Noncontrolling Equity Held Prior to Combination

In some cases, an acquirer may hold an equity interest in an acquiree prior to obtaining control through a business combination. The total amount of the acquirer's investment in the acquiree subsequent to the combination is equal to the acquisition-date fair value of the equity interest previously held and the fair value of the consideration given in the business combination. For example, if Potter Company held 10 percent of Snape Company's stock with a fair value of \$500,000 and Potter acquired the remaining shares of Snape for \$4,500,000 cash, Potter's total investment is considered to be \$5,000,000.

An acquirer that held an equity position in an acquiree immediately prior to the acquisition date must revalue that equity position to its fair value at the acquisition date and recognize a gain or loss on the revaluation. Suppose that Potter's 10 percent investment in Snape has a book value of \$300,000 and fair value of \$500,000 at the date Potter acquires the remaining 90 percent of Snape's stock. Potter revalues its original investment in Snape to its \$500,000 fair value and recognizes a \$200,000 gain on the revaluation at the date it acquires the remaining shares of Snape. Potter records the following entries on its books in connection with the acquisition of Snape:

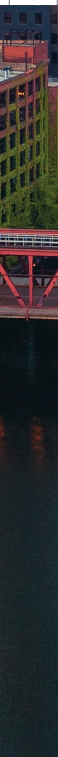
(13)	Investment in Snape Company Stock	200,000	
	Gain on revaluation of Snape Company Stock		200,000
Revalue Snape Company stock to fair value at date of business combination.			
(14)	Investment in Snape Company Stock	4,500,000	
	Cash		4,500,000
Acquire controlling interest in Snape Company.			

SUMMARY OF KEY CONCEPTS

Business combinations and complex organizational structures are an important part of the global business scene. Many companies add organizational components by creating new corporations or partnerships through which to carry out a portion of their operations. In other cases, companies may enter into business combinations to acquire other companies through which to further their objectives.

When a company creates another corporation or a partnership through a transfer of assets, the book values of those assets are transferred to the new entity and no gain or loss is recognized. The creating company and the new entity will combine their financial statements for general-purpose financial reporting to appear as if they were a single company as long as the creating company continues to control the new entity.

A business combination occurs when an acquirer obtains control of one or more other businesses. The three legal forms of business combination that are commonly found are (a) statutory mergers in which the acquiree loses its separate identity and the acquirer continues with the assets and liabilities of both companies; (b) statutory consolidations in which both combining companies join to form a new company; and (c) stock acquisitions in which both combining companies maintain their separate identities, with the acquirer owning the stock of the acquiree.



ASC 805 requires that the acquisition method be used to account for business combinations. Under the acquisition method, all of the assets acquired and liabilities assumed by the acquirer in a business combination are valued at their fair values. The excess of the sum of the fair value of the acquirer's consideration transferred, the fair value of any equity interest in the acquiree already held, and the fair value of any noncontrolling interest in the acquiree over the fair value of the net identifiable assets acquired is goodwill. In subsequent financial statements, goodwill must be reported separately. Goodwill of publicly traded companies is not amortized, but it must be tested for impairment at least annually. If goodwill is impaired, it is written down to its new fair value and a loss is recognized for the amount of the impairment. If the fair value of the consideration transferred by the acquirer in a business combination, along with the fair value of an equity interest already held, and the noncontrolling interest is less than the fair value of the acquiree's net identifiable assets, a situation referred to as a bargain purchase, the difference is recognized as a gain attributable to the acquirer.

All costs associated with a business combination are expensed as incurred. Any stock issue costs incurred in connection with a business combination are treated as a reduction in paid-in capital. A business combination is given effect as of the acquisition date for subsequent financial reporting.

KEY TERMS

acquisition method 14	measurement period 21	special-purpose entity (SPE) 4
bargain purchase 19	minority interest 12	spin-off 5
business combination 7	noncontrolling interest 12	split-off 6
consolidated financial statements 2	parent company 2	statutory consolidation 10
control 7	parent–subsidiary relationship 10	statutory merger 10
differential 16	pooling-of-interests method 8	stock acquisition 10
goodwill 14	primary beneficiary 8	subsidiary 2
holding company 10		tender offer 11
liquidated 10		

QUESTIONS

LO 1–1	Q1–1	What types of circumstances would encourage management to establish a complex organizational structure?
LO 1–1	Q1–2	How would the decision to dispose of a segment of operations using a split-off rather than a spin-off impact the financial statements of the company making the distribution?
LO 1–1	Q1–3	Why did companies such as Enron find the use of special-purpose entities to be advantageous?
LO 1–4	Q1–4	Describe each of the three legal forms that a business combination might take.
LO 1–1	Q1–5	When does a noncontrolling interest arise in a business combination?
LO 1–5	Q1–6	How is the amount reported as goodwill determined under the acquisition method?
LO 1–5	Q1–7	What is a differential?
LO 1–5	Q1–8	When a business combination occurs after the beginning of the year, the income earned by the acquired company between the beginning of the year and the date of combination is excluded from the net income reported by the combined entity for the year. Why?
LO 1–5	Q1–9	What is the maximum balance in retained earnings that can be reported by the combined entity immediately following a business combination?
LO 1–5	Q1–10	How is the amount of additional paid-in capital determined when recording a business combination?
LO 1–5	Q1–11	Which of the costs incurred in completing a business combination are capitalized under the acquisition method?
LO 1–5	Q1–12	Which of the costs incurred in completing a business combination should be treated as a reduction of additional paid-in capital?
LO 1–5	Q1–13	When is goodwill considered impaired following a business combination?