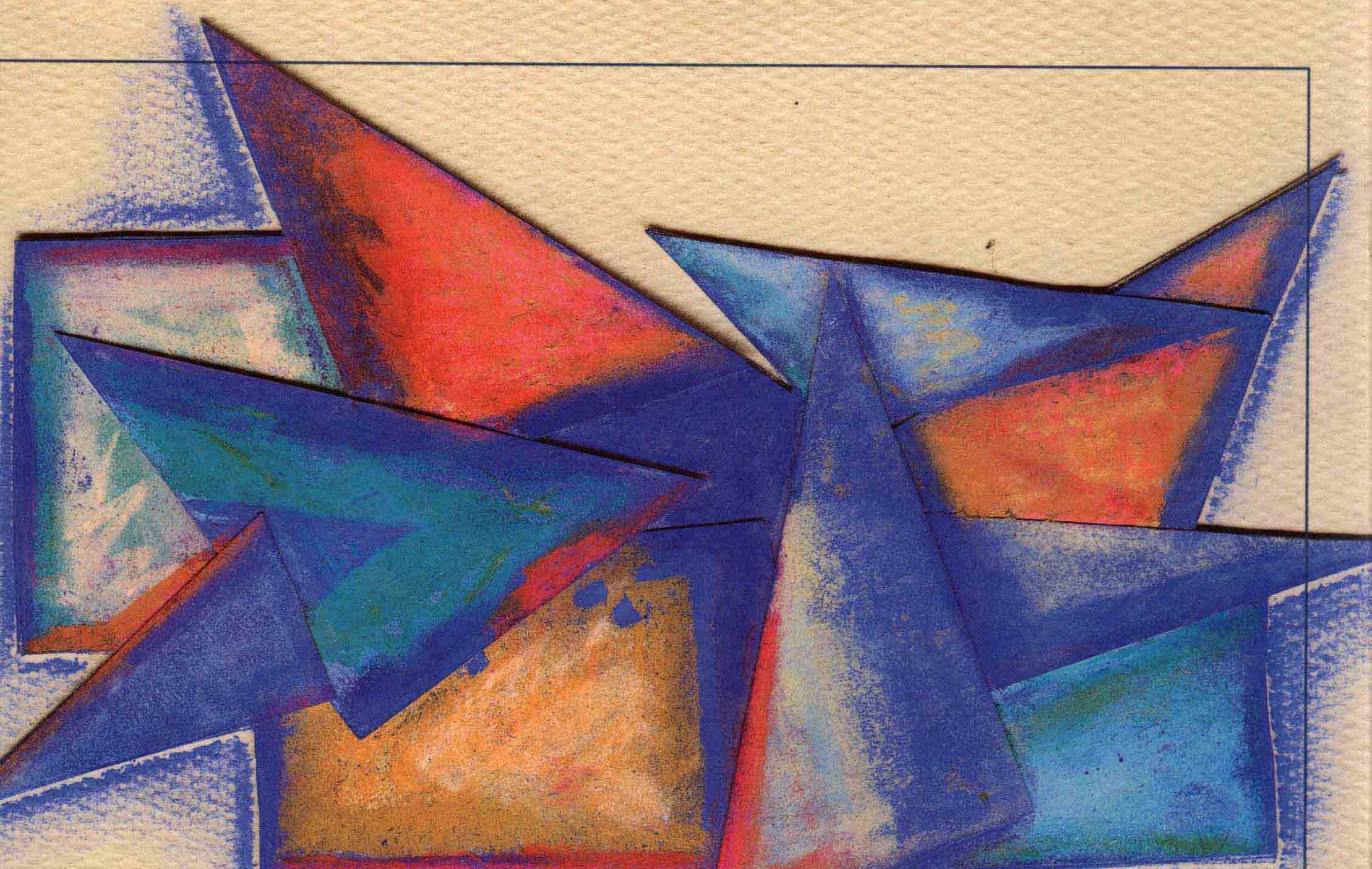
Sixth Edition

ADVANCED ACCOUNTING



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Preface

This sixth edition of *Advanced Accounting* contains twenty-one chapters plus two appendixes and is designed for financial accounting courses above the intermediate level. The sixth edition has been updated to reflect recent business developments and changes in accounting standards and regulatory requirements. The chapter content is revised for better and more efficient coverage. These changes are the result of suggestions received from users and reviewers of earlier editions.

An important feature of this book is its student orientation, and special effort was expended to maintain that emphasis in this sixth edition. The student-oriented features include shading working paper entries, presenting working papers on single, upright pages, and integrating excerpts from business publications and corporate annual reports into the text. A student orientation is also reflected in the assignment material, which is designed to provide variety and maintain student interest. The text includes many exhibits that summarize complex material and both clarify and reinforce the underlying concepts. All exhibits should be read and reviewed in conjunction with the text. The assignment material, including items from past CPA Examinations, is closely aligned with chapter coverage. In addition, the names of parent and subsidiary companies begin with P and S for convenient identification and reference.

NEW TO THIS EDITION

The important changes in this sixth edition of *Advanced Accounting* include:

- Coverage of the consolidated statement of cash flows has been moved from Chapter 3 to an appendix to Chapter 4. The primary reason for this change is that consolidated cash flow statements are prepared from consolidated balance sheets and consolidated income statements. Chapter 4 covers the construction of consolidated financial statements that provides valuable background for understanding consolidated cash flows statements.
- Chapter 14, "Foreign Currency Financial Statements," has been reorganized and the coverage of the cash flows statement with a new illustration has been moved to an appendix to Chapter 14. In this way, the translation and consolidation of a foreign subsidiary with minority interest can be examined separately without the additional complexities that arise from using the same illustration for both consolidation and the cash flows statement.

- Chapters 19 and 20 provide an introduction to accounting for state and local governments, an area where rapid changes are taking place. These chapters have been updated for the recent pronouncements, including the three new pension standards.
- The biggest changes in the sixth edition are in Chapter 21 on accounting for not-for-profit organizations. The chapter has been updated for *FASB Statements 116* and *117*. In addition, the chapter covers essential differences in accounting for governmental and nongovernmental not-for-profit organizations.

ORGANIZATION

The first eleven chapters cover business combinations, the equity and cost methods of accounting for investments in common stock, and consolidated financial statements. This emphasis reflects the importance of business combinations and consolidations in advanced accounting courses as well as in financial accounting and reporting practices.

Accounting standards for business combinations under the purchase and pooling of interests methods are introduced in Chapter 1, along with applicable accounting and reporting standards. Chapter 1 also provides relevant background material relating to the form and economic impact (including human costs) of business combinations. The Financial Accounting Standards Board has indicated that it plans to move toward aligning the standards of U.S. generally accepted accounting principles with those of other nations, particularly those of our NAFTA trading partners. For example, the standard-setting boards of the United States and Canada have held joint meetings in their deliberations on revised segment reporting principles and the FASB's stated objectives for a new earnings per share standard include making EPS computations similar to those of other countries. In light of this trend, it is likely that the long-awaited standards for consolidation principles will also reflect some movement toward international standards. Differences in international accounting related to business combinations are introduced in Chapter 1.

The equity method of accounting as a one-line consolidation is discussed in Chapter 2 and integrated throughout subsequent chapters on consolidations. This parallel one-line consolidation/consolidation coverage permits alternate computations for such key concepts as consolidated net income and consolidated retained earnings and helps the instructor explain the objectives of consolidation procedures. It also permits students to check their logic by alternative approaches to key computations.

The one-line consolidation is established as the standard of parent company accounting for its subsidiaries, but the coverage does not ignore situations in which the parent company uses the cost method or an incomplete equity method to account for its subsidiaries and other investees. These methods are illustrated in the text and included in assignment material so that students are prepared for consolidation assignments regardless of the method used by the parent company in accounting for its subsidiary investments.

Accounting and reporting matters related to pooled subsidiaries are integrated into Chapters 3 through 11. Consolidated financial statements and push-down accounting are introduced in Chapter 3. Also new to this edition is an illustration of the FASB's proposed allocation of the purchase price to the total fair values of the subsidiary's identifiable net assets and purchased goodwill (sometimes called the economic unit concept—purchased goodwill approach).

Chapter 4 introduces the student to consolidation working paper techniques and procedures. The three-section financial statement working paper approach is presented as basic, but the trial balance approach is also illustrated and included in the problem material. Consolidation working papers for a parent company that uses the equity method as a one-line consolidation are presented first to set the standard. Subsequently, working papers are illustrated under an incomplete (or simple) equity method and the cost method, both for the year of acquisition and the following year.

Consolidation under the cost and incomplete equity methods are illustrated using the traditional approach (alternate working paper entries) or the conversion to equity approach (adjust to the equity method through a schedule and a working paper entry).

Intercompany transactions involving inventories, plant assets, and bonds are covered in Chapters 5, 6, and 7. Chapter 8 covers ownership changes in subsidiaries.

Chapter 9 covers complex affiliation structures, and Chapter 10 covers subsidiary preferred stock, consolidated earnings per share, and income taxation for consolidated entities. The coverage of tax considerations for business combinations has been expanded.

Chapter 11 covers consolidation theories, leveraged buyouts, push-down accounting, and corporate joint ventures. An appendix to the chapter discusses current cost implications for consolidations. Since Chapters 9, 10, and 11 cover specialized topics, their coverage is not essential background for assignment of subsequent chapters.

Chapter 12 covers accounting and reporting practices for branch operations, including the use of perpetual inventory practices in the combining working papers. The use of perpetual inventory procedures makes the combining working paper entries for branches compatible with those for consolidations.

Foreign currency issues continue to be important to American business enterprises. The survival of many American businesses depends on access to foreign markets, suppliers, and capital. Chapter 13 covers foreign currency transactions, including imports and exports and forward contracts. Chapter 14 covers translation and remeasurement of foreign entity financial statements; one-line consolidations of equity investees; consolidation of foreign subsidiaries for external reporting purposes; and combining foreign branch operations.

Chapter 15 examines disclosures for industry segments and interim financial reporting, Chapter 16 covers organization, operations, and dissolution of partnership entities, and Chapter 17 extends partnership coverage to liquidations.

Chapter 18 covers corporate liquidations, reorganizations, and debt restructurings for financially distressed companies. This chapter has been updated for the 1994 Bankruptcy Reform Act. Reorganization under Chapter 11 of the Bankruptcy Code is illustrated using fresh start reporting as described in the AICPA's SOP 90-7. Troubled debt restructurings have been updated for *FASB Statement No. 114*.

Chapters 19 and 20 provide an introduction to governmental accounting, and the final chapter (Chapter 21) introduces accounting for voluntary health and welfare organizations, hospitals, and colleges and universities.

Appendix A provides an overview of SEC accounting requirements, and Appendix B provides a review of fiduciary accounting for estates and trusts.

SUPPLEMENTARY MATERIALS

The supplementary materials for the sixth edition of *Advanced Accounting* include three manuals:

- The solutions manual
- A resource manual that contains (a) comprehensive outlines of all chapters, (b) class illustrations, (c) descriptions of all exercises and problems, including estimated times to complete, (d) alternative lesson plans covering different chapters, and (e) a checklist for students of key figures in the problems.
- A test bank manual

The following additional material is available to adopters:

- Transparencies for solutions to exercises and problems
- A diskette containing test material (This is the same as the material contained in the manual.)
- Lotus spreadsheet templates for consolidation and other working paper problems
- Partially completed working papers for consolidation and other working paper problems in the textbook (These working papers are hard copy of the Lotus templates included on the diskettes.)

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My sincere appreciation is extended to Paul A. Copley of the J.M. Tull School of Accounting, The University of Georgia, and Nabil Hassan, Wright State University, for their reviews and thoughtful comments and valuable suggestions. Craig D. Shoulders of Virginia Tech and Gary Cunningham of Bryant College also provided valuable suggestions and direction for this sixth edition. Several other friends and colleagues have provided comments and materials that contributed significantly to this text. They are Jerrell W. Habegger, Susquehanna University; James Chiu, California State University, Northridge; Lola Rhodes, University of Texas at Arlington; Joanne Rockness, North Carolina State University; and James D. Stice, Brigham Young University. I thank Maureen Wilson, Paul Smolenski, Jayne Conte, Pat Wosczyk, Jane Avey, Diane deCastro, P.J. Boardman, Rich Wohl, and Debbie Emry of Prentice Hall for their valuable support and encouragement.

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ADVANCED ACCOUNTING

Contents

1

Business Combinations

A **business combination** is the union of business entities. Uniting separate business entities is an alternative to internal expansion through the acquisition or development of business property on a piecemeal basis, and it frequently offers advantages to all the combining entities and their owners.

THE NATURE OF BUSINESS COMBINATIONS

Although the overriding objective of business combinations must be profitability, the immediate concern of many combinations is to gain operating efficiencies through horizontal or vertical integration of operations or to diversify business risks through conglomerate operations.

Horizontal integration is the combination of firms in the same business lines and markets. An example of horizontal integration is Corning, Inc.'s acquisition of Damon Corporation in 1993 that combined two companies with clinical laboratories that test blood, body fluids, and tissue for physicians and hospitals. The 1993 business combination of Mattel, Inc., and Fisher-Price, Inc., in the toy industry is another example of horizontal integration.

Vertical integration is the combination of firms with operations in different, but successive, stages of production and/or distribution. Merck & Co., one of the nation's largest drug producers, acquired Medco Containment Services, Inc., a major distributor of prescription drugs, in 1993. The combined vertically integrated company expected to reduce the cost of delivering drugs to the market.

Conglomeration is the combination of firms with unrelated and diverse products and/or service functions. Firms may diversify to reduce the risk associated with a particular line of business, or to even out cyclical earnings, such as a utility's acquisition of a manufacturing company. In 1994 many drug companies were combining with other drug companies to increase their size (horizontal integration). Other drug companies combined with pharmacy-benefit-management companies to create expanded markets for their drugs (vertical integration). At the same time, however, a few were diversifying. An example is Sandoz Ltd.'s acquisition of Gerber Products Co., a baby-food company (conglomeration).

Antitrust Considerations

Federal laws prohibit business combinations that would be in restraint of trade or that would impair competition. Proposed business combinations are scrutinized by governmental agencies such as the Justice Department, the Federal Trade Commission, the Federal Reserve Board, the Department of Transportation, and the Securities and Exchange Commission, and a number of them are found to be in violation of federal law. General Mills, Inc.'s planned acquisition of RJR Nabisco's Shredded Wheat business was halted because of objections raised by the Federal Trade Commission. ChipSoft, Inc.'s planned merger with Meca Software, Inc., was called off after the Justice Department threatened to challenge it as anticompetitive. Business combinations in particular industries are subject to review by additional federal agencies. For example, the Department of Energy has jurisdiction over some electric utility mergers and the Federal Communications Commission rules on the transfer of communication licenses.

In addition to federal antitrust laws, many states also have statutes limiting certain mergers deemed to be anticompetitive. In 1990 American Stores Co. agreed to sell one of its grocery store chains in settlement of an antitrust suit brought against it by the state of California. The suit stemmed from the company's acquisition of Lucky Stores to which the federal government had not objected.[1] Some state statutes are aimed at preventing or delaying hostile takeovers of their incorporated business enterprises. By mid-1994, 41 states had passed some type of statutory takeover regulations. Contrarily, some states have passed antitrust exemption laws to protect hospitals pursuing cooperative projects from antitrust laws.

Interpretations of antitrust laws vary from one administration to another, from department to department, and from state to state. Even the same department under the same administration can change its mind. The Federal Trade Commission (FTC) reviewed and cleared Merck & Co.'s acquisition of Medco Containment Services. Inc. and SmithKline Beecham PLC's acquisition of Diversified Pharmaceutical Services and both mergers were completed in 1994. But in November 1994, the FTC reopened its examination of both mergers, citing its concern about the impact of vertical integration on competitiveness. The FTC can reexamine mergers at any time. Disputes are settled in the courts.

Impact of Business Combinations

Several periods of merger and acquisition activity in the United States have been identified as boom periods because of the increased number and dollar volume of transactions. These periods include the monopoly-building period in the late 1800s, the oligopoly period in the 1920s, and the 1955–1969 conglomerate period. Dozens of disparate companies could be combined into a single conglomerate. Ultimately, the giant conglomerates became unwieldy and profits lagged. In the 1980s, often referred to as the restructuring years, corporations tried to improve profitability by selling companies not related to their core businesses. ITT, for example, sold about 240 companies from 1979 to 1994. Many mergers and acquisitions in the 1980s were made by "financial buyers" (a term used to describe corporate raiders and buyout specialists whose deals were designed for quick profits from financial maneuvers, rather than for business expansion). The mergers were accomplished with debt and the ratio of debt to owners' equity rose to 52 percent during the decade. After reaching a high in the total value of mergers and acquisitions of $246.9 billion in 1988, the level of activity dropped sharply for several years before rebounding in 1993. Mergers and acquisitions in the 1990s have tended to be "strategic acquisitions" (in other words, acquisitions within related fields that have a real business purpose), and many are financed with stock rather than debt. Conglomerates in the 1990s generally have fewer different businesses than in the 1960s.

For the economy as a whole, mergers reshuffle the ownership of corporate assets without increasing the nation's supply of productive resources.

[1] In *California* v. *American Stores Co.*, the Supreme Court ruled that states may sue in federal court to dismantle mergers that state officials believe are anticompetitive.

The Human Cost of Business Combinations

Business combinations provide opportunities for people to gain power and make money. But business combinations almost always result in some people losing their jobs. In a survey of executive stress, 54 percent of the respondents listed "loss of job due to merger or acquisition" as their greatest anxiety.[2]

Insight into the human cost of business combinations is provided in an article describing the leveraged buyout of Safeway Stores, Inc.[3] When Herbert and Robert Haft offered to buy Safeway, the company escaped the takeover by selling instead to an investor group led by Kohlberg Kravis Roberts & Co. (KKR), and including Safeway's top management, in a $5.65 billion leveraged buyout. In a leveraged buyout (LBO), an investor group acquires a company from the public shareholders in a transaction financed almost entirely with debt.

Many people made money on this LBO. Safeway stockholders and the top management that participated in the LBO made money. The Hafts made $100 million by selling their shares of Safeway stock to KKR. They made another $59 million from an option they received as consolation for losing the takeover fight. Fees of $65 million went to three investment banks; $60 million went to KKR; and $25 million went to law and accounting firms.

Sixty-three thousand managers and workers lost their jobs with Safeway because of the leveraged buyout—some through the sale of stores and some through layoffs. Many of these workers were rehired by new store owners, but at lower wages. Thousands were forced to take part-time work (with no benefits); or remained unemployed. In addition to the Safeway workers who lost their jobs, hundreds of employees of businesses dependent on Safeway were laid off.

The new LBO company instituted cost-cutting measures and high-pressure quota systems. This, in turn, created dissatisfaction among the remaining employees who often complained about being overworked. And there was the constant worry about job security. Labor unions were forced to make concessions to prevent further layoffs.

But these are not the costs that accountants measure.

Reasons for Business Combinations

If expansion is a proper goal of business enterprise, why does a business expand through combination rather than by construction of new facilities? Among the many possible reasons for electing business combination as the vehicle for expansion are:

Cost Advantage. It is frequently less expensive for a firm to obtain needed facilities through combination than through development. This is particularly true in periods of inflation.

Lower Risk. The purchase of established product lines and markets is usually less risky than developing new products and markets. Business combination is especially less risky when the objective is diversification. It is often pointed out that MBAs are well schooled in mergers and acquisitions, but know very little about production. By 1993 nearly all branches of the health care industry were trying to consolidate because of uncertainties about health care reform. The companies felt they would be better able to negotiate with managed care providers if they were larger and offered a more comprehensive array of services.

Fewer Operating Delays. Plant facilities acquired through a business combination can be expected to be operative and to meet environmental and other governmental regulations. But firms constructing new facilities can expect numerous delays in construction as well as in getting the necessary governmental approval to commence operations. Construction on the Tellico Dam in Tennessee was held up for five years to preserve a small fish known as the snail darter. Environmental impact studies alone can take months or even years to complete.

Avoidance of Takeovers. Some companies combine in order to avoid being acquired themselves. Since smaller companies tend to be more vulnerable to corporate takeovers,

[2]Robert Half International in *Journal of Accountancy* (December 1989), p. 22.

[3]Susan C. Faludi, "The Reckoning," *Wall Street Journal*, May 16, 1990, pp. A1, A8, and A9. See Chapter 11 for additional information on leveraged buyouts.

many of them adopt aggressive buyer strategies as the best defense against takeover attempts by other companies. Companies with high debt-equity ratios usually are not attractive takeover candidates. In the banking industry, for example, independent banks acquire neighboring banks to gain market share and grow into regional banks. The banks use combination as a way to avoid being taken over by out-of-state banks.

Acquisition of Intangible Assets. Business combination involves the combining of intangible, as well as tangible, resources. Thus, the acquisition of patents, mineral rights, customer databases, or management expertise may be a primary motivating factor in a particular business combination. One reason for Merck & Co.'s 1993 acquisition of Medco Containment Services was Medco's valuable patient database that detailed drug prescriptions for 33 million people. Merck used the database to determine which prescriptions might be switched to a Merck product.

Other Reasons. Firms may choose business combination over other forms of expansion for business tax advantages (for example, tax-loss carryforwards), for personal income and estate tax advantages, and for personal reasons. The egos of company management and takeover specialists also play an important role in some business combinations.[4]

THE FORM OF BUSINESS COMBINATIONS

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

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

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

A *consolidation* occurs when a new corporation is formed to take over the assets and operations of two or more separate business entities and those previously separate entities are dissolved. For example, Company D, a newly formed corporation, may acquire the net assets of Companies E and F by issuing stock directly to Companies E and F. In this case, Companies E and F may continue to hold Company D stock for the benefit of their stockholders (an acquisition), or they may distribute the Company D stock to their stockholders and go out of existence (a consolidation). In either case, Company D acquires ownership of the assets of Companies E and F. Alternatively, Company D could issue its stock directly to the stockholders of Companies E and F in exchange for a majority of their shares. In this case, Company D controls the assets of Company E and Company F, but it does not obtain legal title unless Companies E and F are dissolved. Company D must acquire all the stock of Companies E and F and dissolve those companies if their business combination is to be a consolidation. If Companies E and F are not dissolved, Company D will operate as a *holding company*, and Companies E and F will be its *subsidiaries*.

[4]Many interesting and entertaining books have been written about corporate takeover battles. For example, *Barbarians at the Gate* by Bryan Burrough and John Helyar (New York: Harper & Row, 1990) describes in detail the leveraged buyout of RJR Nabisco, and *Merger* by Peter F. Hartz (New York: William Morrow, 1985) describes the unsuccessful takeover attempt of Martin Marietta by Bendix Corporation.