

7th Edition

# ADVANCED C C O U N T I N G



Fischer, Taylor, & Cheng

# *Advanced Accounting*

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SEVENTH EDITION

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Cover Designer:	Ann Small/A Small Design Studio
Cover Illustrator:	copyright/Garneau/Provost/SuperStock
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Cincinnati, Ohio

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Library of Congress Cataloging-in-Publication Data:

Fischer, Paul M.

Advanced accounting / Paul M. Fischer, William J. Taylor,  
Rita H. Cheng. — 7th ed.

p. cm.

Includes bibliographical references and index.

ISBN 0-538-86655-1

1. Accounting. I. Taylor, William James. II. Cheng, Rita H., 1952-  
III. Title.

HF5635.F5389 1998

657'.046—dc21

98-3027

CIP

Student Edition, Chapters 1–21 ISBN: 0-538-86655-1

2 3 4 5 6 7 8 9 D1 5 4 3 2 1 0 9 8  
Printed in the United States of America

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# Preface

## Follow the Leader

### Clear. Conceptual. Comprehensive.

With a strong tradition of combining sound theoretical foundations with a hands-on learn-by-example approach, this book has earned itself a prominent place in advanced accounting classrooms across the country. In this Seventh Edition, we build on *Advanced Accounting's* clear writing style, comprehensive coverage, and focus on conceptual understanding. This edition expands on its time-tested and proven approach by adding new features that enhance comprehension and knowledge, as well as topics and issues that are timely.

Realizing that students reap the greatest benefits when they can visualize the application of theories, *Advanced Accounting* closely links theory and practice by providing examples that are common to real-world accounting. When students can visualize the concept being discussed and apply it directly to an example, their understanding greatly improves. This focus on conceptual understanding makes even the most complex topics approachable. Questions are used to reinforce theory, and exercises are short, focused applications of specific topics in the chapter. These exercises make great assignments to be done prior to class. The book's problems—more comprehensive than the exercises—often combine topics and are designed to work well as after-class assignments. For group projects, the cases found in the business combinations chapters provide an innovative way to blend theoretical and numerical analysis.

Ideal for student self-study and unique to *Advanced Accounting* is the *Student Companion Enrichment Manual*. With step-by-step application of the methods discussed in the text, as well as a complete study guide, the enrichment manual reinforces student understanding and helps students in their mastery of text subject matter. See page viii for more information on the Enrichment Manual.

Of importance to both instructors and students is the emphasis on accuracy in both the book and supplementary items. Through meticulous

proofing and quality control, we have taken great strides to ensure its error-free content. Each author has carefully proofread the chapters, and an editor has gone over the content to ensure accuracy. In addition, all the ancillaries have been reviewed and checked by highly qualified individuals.

## Comprehensive

### *Highlights of Changes in the Seventh Edition*

*Advanced Accounting*, Seventh Edition, reflects changes in accounting procedures and standards while improving on those features that aid in student comprehension. The book's authorship now includes Rita Cheng of the University of Wisconsin, Milwaukee, a well-respected educator in the governmental and not-for-profit accounting arena.

New features of this edition include:

- *Expanded coverage of the pooling-of-interests method.* Chapter 1 takes a more in-depth look at the comparison of pooling versus purchase and analyzes the current increase in pooling. It also focuses on the motivation to use this method to enhance performance measures. An actual case is used to demonstrate the financial reporting advantages of pooling.
- *Changes in accounting and business combinations procedures that may take place in the coming years.* The impact of these changes on current GAAP methods used in the text is analyzed. Many of the methods used in the text, such as disclosure of the minority interest and 100% elimination of intercompany profits, are ratified by the FASB proposals.
- *Two new special appendices that focus on the existing FASB proposals for new consolidation procedures.* The first appendix, Special Appendix 1, follows Chapter 3 and focuses on the mark to market the noncontrolling interest (currently the minority interest). Following Chapter 8, Special Appendix 2 studies the possible changes in accounting for changes in the level of parent ownership and changes in the subsidiary equity structure.

- *Substantial improvements and updated coverage in accounting for the taxation of the consolidated firm.* New support schedules guide the worksheet procedures for consolidated firms, which are taxed as separate entities.
- *Enhancements of the very popular Determination and Distribution of Excess Schedule.* "Zone Analysis" is now included in the scheduling process, allowing students to determine in advance if the price will allow goodwill, be a bargain, or result in a deferred credit.
- *Simplified worksheet procedures for intercompany fixed asset sales and for intercompany inventory transactions, where the periodic inventory method is used.* Chapter 4 includes this easier approach for students.
- *Substantial revision of end-of-chapter assignments.* There is an expanded use of cases to study alternative accounting methods for business combinations. These cases build an awareness of the important issues now under consideration by the FASB.
- *A study of the specific differences between accounting procedures in the United States and selected major foreign countries.* The countries are compared by cultural classification and selected accounting principles. Chapter 9 also studies the development of international accounting standards and identifies areas which differ from existing U.S. GAAP. The material on foreign currency transactions has been revised to reflect the FASB exposure draft on derivatives.
- *Coverage of SFAS No. 131 (segmental reporting).* Financial disclosure for segments has been made less structured and more consistent with internal measurement methods. This edition includes a full discussion of the new procedures and illustrates their application.
- *Coverage of SFAS No. 128 (earnings per share).* Our traditional, unique, and simplified formula approach has been revised to insure clear explanation and illustration of the new calculations of earnings per share.
- *A discussion of recent developments in state and local government financial reporting, including the GASB's efforts to develop a new reporting model.* In addition to the reporting model, this edition also incorporates the new GASB guidance on accounting for pensions, for recognition of assets and liabilities and related disclosures arising from securities lending transactions, accounting for certain investments at fair value, and additional coverage of key issues in governmental audit, including the single audit act.
- *An appendix detailing the proposed dual-perspective financial reporting model.* At the end of Chapter 17, the unique features of the dual perspective are presented.
- *Revised coverage of FASB 116, 117, and 124 in the not-for-profit chapters.* The same transactions are used for the nonprofit organizations as for the governmental units, so that the student will clearly see the differences in the methods used.
- *Enhanced coverage throughout the government and not-for-profit chapters.* Improvements in the text, illustrations, and end-of-chapter materials are aimed at making the presentation more conceptual and less procedural. The aim is to provide students with an understanding of the unique features of the changing government and not-for-profit accounting environment.

### Clear. Conceptual.

### *Organization of the Book*

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

The text is divided into the following major topics:

#### BUSINESS COMBINATIONS—BASIC TOPICS (CHAPTERS 1–6)

A unique feature of this book is the devotion of the first chapter to the basic issues of purchase and pooling-of-interests accounting in the context of direct asset acquisitions. This provides an opportunity to focus on theoretical concepts without being concerned about the mechanics of consolidations. The most difficult concept in the chapter is the combining of stockholders' equities in a pooling of interests, and this is aided by a unique "equity transfer diagram." Chapter 1 also takes an in-depth look at the comparison of pooling versus purchase and analyzes the current increase in pooling. We use a real-world case to demonstrate the financial reporting advantages of pooling.

Chapters 2 through 5 cover the basics of preparing a consolidated income statement and balance sheet.

In 1977, we introduced two schedules that have been much appreciated by students and faculty alike—the *Determination and Distribution of Excess Schedule* and *Income Distribution Schedule*. The determination and distribution schedule (quickly termed the D&D schedule by students) analyzes the difference between the price paid in a purchase and the underlying equity of the subsidiary. It provides a check figure for all subsequent years' worksheets, provides all information for the distribution of differences between book and market values, and provides all data for the amortization of the differences. The schedule provides rules for all types of purchase situations and for alternative consolidation theories. The income distribution schedule (known as the IDS) is a set of T accounts that distributes income between the minority and controlling interests. It also provides a useful check function to assure that all intercompany eliminations are properly accounted for. These chapters give the student all topics needed for the CPA Exam. Special Appendix 1, which follows Chapter 3, focuses on the marking to market of the noncontrolling (currently the minority) interests.

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

We also cover the sophisticated equity method, which amortizes the excess of cost or book value through the investment account. This method should also adjust for intercompany profits through

the investment account. The method is cumbersome because it requires the student to deal with amortizations of excess and intercompany profits in the investment account before getting to the consolidated worksheet, which is designed to handle these topics. This means teaching consolidating procedures without the benefit of a worksheet. We cover the method after the student is proficient with a worksheet and the other methods. Thorough understanding of the sophisticated method is important so that it can be applied to influential investments that are not consolidated.

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

Chapter 6 is more essential for those entering practice than it is for the CPA Exam. It contains cash flow for consolidated firms, taxation issues, and the use of the sophisticated equity method for influential investments. This edition makes substantial improvements in accounting for the taxation of the consolidated company. New support schedules guide the worksheet procedures for consolidated companies, which are taxed as separate entities. Taxation is the most difficult application of consolidation procedures. Every intercompany transaction is a tax allocation issue. Teaching the tax allocation issues with every topic as it is introduced is very confusing to students. We prefer to have the students fully understand worksheet procedures without taxes and then introduce taxes.

#### BUSINESS COMBINATIONS—SPECIALIZED TOPICS (CHAPTERS 7 AND 8)

These chapters deal with topics that occasionally surface in practice and have not appeared on the



CPA Exam for over 10 years. Studying these chapters perfects the students' understanding of consolidations and stockholders' equity accounting, thus affording a valuable experience. Chapter 7 deals with piecemeal acquisitions of an investment in a subsidiary, sale of the parent's investment, and the impact of preferred stock in the subsidiary's equity structure. Chapter 8 deals with the impact of subsidiary equity transactions including stock dividends, sale of common stock shares, and subsidiary reacquisitions of shares. The chapter also considers indirect or three-tier ownership structures and reciprocal holdings where the subsidiary owns parent shares. Following Chapter 8, Special Appendix 2 studies the possible changes in accounting for changes in the level of parent ownership and changes in the subsidiary equity structure.

#### BUSINESS COMBINATIONS—SPECIAL APPENDICES

The Special Appendices 1 and 2 should not be dismissed from the study plan for a semester. The material on alternative consolidation theories is conceptually important. It summarizes FASB's 1995 Exposure Draft and compares alternative theories to current practice. Studying it reinforces the students' understanding and prepares them for changes that may occur. Generally, students find this material very interesting. The first one follows Chapter 3. It summarizes the Parent Company theory and explains two approaches to the Economic Unit Concept. Special Appendix 2 appears after Chapter 8. It explains additional possible changes to consolidation practice based on the FASB proposal.

Special Appendix 3 explores accounting for leveraged buyouts. This is a popular topic and is easily mastered using consolidation techniques. Students enjoy mastering it since it is a common business phenomenon that sounds difficult but really isn't. It particularly appeals to students with an interest in financial management.

#### MULTINATIONAL ACCOUNTING (CHAPTERS 9–11)

As business has developed beyond national boundaries, the discipline of accounting also has evolved internationally. As our global economy develops, so does the demand for reliable and comparable financial information. Chapter 9 discusses the international accounting environment and compares accounting principles among several countries. This comparison illustrates for the need for accounting standards to be in harmony with each other. Approaches to the harmonization of standards and the various organizations involved are identified.

Chapter 10 discusses accounting for foreign currency transactions. The basic mechanics of exchange rates and the business risks resulting from exchange rate changes are set forth. The use of forward contracts as a hedge against rate change fluctuations is discussed, and the accounting for such hedges is demonstrated. Chapter 11 demonstrates the remeasurement and/or translation of a foreign entity's financial statements into a U.S. investor's currency. Whenever possible, examples of footnote disclosure relating to international accounting issues are presented.

#### SPECIAL REPORTING CONCERNS (CHAPTERS 12 AND 13)

The usefulness of financial information naturally increases if it is communicated on a timely basis. Therefore, interim financial statements and reporting requirements are now widely accepted. In Chapter 12, the concept of an interim period as an integral part of a larger annual accounting period is set forth as a basis for explaining the specialized accounting principles of interim reporting. Particular attention is paid to the determination of the interim income tax provision including the tax implications of net operating losses. Chapter 12 also examines segmental reporting and the various disclosure requirements. A worksheet format for developing segmental data is used, and students are able to review the segmental footnote disclosure for a large public company. The section on segmental reporting has been significantly updated to reflect the new FASB Statement No. 131.

In Chapter 13, students are given a comprehensive discussion of the disclosure of earnings per share data in compliance with FASB statement No. 128. Supporting schedules are used to facilitate the calculation of per share amounts. The calculation of basic earnings per share is developed, and then, with that background, students are exposed to the calculation of diluted earnings per share. The chapter concludes with a comprehensive illustration dealing with the calculation of both basic and diluted earnings per share.

#### ACCOUNTING FOR PARTNERSHIPS (CHAPTERS 14 AND 15)

Chapters 14 and 15 take students through the entire life cycle of a partnership, beginning with formation and ending in liquidation. Although new forms of organization, such as the limited liability corporation, are available, partnerships continue to be a common form of organization. Practicing accountants must be aware of the characteristics of this form of organization and the unique accounting

principles. The accounting aspects of profit and loss agreements, changes in the composition of partners (admissions and withdrawals), and partnership liquidations are fully illustrated. In addition to accounting principles, certain income tax principles relating to partnerships are set forth. The end-of-chapter material in this area focuses on evaluating various alternative strategies available to partners, for example, deciding whether it would be better to liquidate a partnership or admit a new partner.

#### GOVERNMENTAL AND NOT-FOR-PROFIT ACCOUNTING (CHAPTERS 16–19)

Chapters 16 and 17 have been updated to include recent Governmental Accounting Standards Board (GASB) pronouncements. Chapter 16 includes a complete discussion of measurement focus and basis of accounting issues for state and local governments. The deferral of GASB Statement No. 11 and the issues involved in the deliberation of a new “dual perspective” financial reporting model are outlined for the reader.

In Chapter 16, we introduce the unique accounting and financial reporting issues of state and local governments. The chapter also covers the basics of accounting and financial reporting for the general fund and the two account groups. This order emphasizes the “working capital” focus of the general fund and the resulting need to account for fixed assets and long-term liabilities elsewhere.

Chapter 17 covers the accounting and financial reporting of the specialized funds of government: those established to account for restricted operating resources, long-term construction projects or acquisition of major fixed assets, and servicing of principal and interest on long-term debt. The chapter also covers the unique accounting issues of various trust funds and proprietary (business-type) funds.

Chapters 18 and 19 include revised coverage of Financial Accounting Standards Board (FASB) 116, 117, and 124 for such organizations as private not-for-profit health care entities, private universities, and voluntary health and welfare organizations. The same transactions are used for the nonprofit organizations as for the governmental units, allowing students to clearly see the differences in the methods used. The standards define how the resources of a private not-for-profit organization are to be divided into unrestricted, temporarily restricted, or permanently restricted net asset classifications. Financial statements also are based on net asset classifications. The new standards represent a shift away from fund accounting to organi-

zation-wide financial reporting. A statement of cash flows is now required. The chapters also cover the updated guidance in the 1996 industry audit guides.

In Chapter 18, we provide an overall summary of the new accounting and financial reporting standards as they apply to all not-for-profit organizations. We then offer a complete description of accounting and illustrations of the financial reports of public universities. Since the GASB has not changed accounting for the public universities, these organizations will continue to follow the “old” version of the AICPA audit guide. The next section in this chapter illustrates accounting and financial reporting for private not-for-profit organizations following the new FASB guidance. For ease of presentation, these illustrations are presented without regard to a fund structure. However, since the new FASB guidance does not preclude funds-based reporting, an appendix is included incorporating the new standards within the existing funds structure. This gives the instructor the option of teaching the material for private universities with or without funds.

Chapter 19 covers accounting and financial reporting for health care entities and voluntary health and welfare organizations. The chapter also incorporates for each type of organization the most recent FASB standards in addition to the 1996 updated AICPA audit guide. In this chapter, funds are viewed as internal control and management tools. External financial statements are illustrated without a funds structure. As in Chapter 18, however, a funds-based illustration is included in the appendix for both health care organizations and voluntary health and welfare organizations.

Throughout the government and not-for-profit chapters, improvements in the text, illustrations, and end-of-chapter materials are aimed at making the presentation more conceptual and less procedural. The aim is to provide students with an understanding of the unique features of the changing government and not-for-profit accounting environment.

#### FIDUCIARY ACCOUNTING (CHAPTERS 20 AND 21)

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

No business is immune from financial difficulty. Chapter 21 discusses various responses to



such difficulties, including troubled debt restructuring, quasi-reorganizations, corporate liquidations, and corporate reorganizations.

## Supplementary Materials

### For the Instructor

*Solutions Manual.* This manual provides descriptions of all exercises, problems, and cases with their estimated completion time. You'll find answers to all end-of-chapter questions and solutions to all exercises, problems, and cases, along with the logic for the solutions when appropriate. In particular, answers to multiple-choice questions include supporting explanations and computations.

*Transparencies.* The set of transparencies contains blank worksheets, solutions for all of the consolidation problems, and selected solutions from the remainder of the text.

*Test Bank.* This resource, available in both print and electronic formats, contains multiple-choice questions and examination problems for each chapter along with the solutions. These materials may be reproduced by the instructor. The electronic test bank is Windows® based.

*Excel® Templates.* Both student and solutions templates for use with Excel® are available. The templates, for use with selected problems from the text, are for use with selected nonconsolidation chapters as well as the consolidation chapters. Instructors may choose from horizontal and vertical presentations for the consolidation assignments.

*PowerPoint® Presentations.* Author-designed electronic slides are available to enrich classroom teaching of concepts and practice.

### For the Student

*Student Companion Enrichment Manual.* This manual greatly enhances student self-study. With step-by-step application of the methods discussed in the text, the enrichment manual helps students in their mastery of text subject matter. The manual is composed of three main sections: the Text Companion, the Enrichment, and the Study Guide. The Text Companion section contains the worksheets from Chapters 2–8 and 11 and the Special Appendices reproduced on removable pages to give students

easy reference as they study the related text narrative. Also in the Text Companion section are several supporting examples, diagrams, and illustrations to assist understanding of complex topics. The Enrichment section contains coverage of branch accounting and the SEC as background information for the students. The Study Guide section contains a detailed outline of each chapter and several learning activities, such as true/false, multiple choice, and matching questions, as well as short problems. The solutions for these activities appear at the end of the section.

*Working Papers for Consolidations.* The working papers for solving the consolidation problems in Chapters 2–8 and Chapter 11 contain printed trial balances as a means of saving time. The pages are bound in a single volume and are perforated for easy removal. Blank worksheets are included at the end for extra assignments.

## Acknowledgments

We are grateful to the following people for their important contributions to ensure a high-quality text and ancillaries:

Bruce C. Branson, *North Carolina State University*  
 Arthur S. Boyett, *Francis Marion University*  
 Frank Cicalese, *Kean University of New Jersey*  
 Teresa L. Conover, *University of North Texas*  
 Constance J. Crawford, *Ramapo College of New Jersey*  
 John E. Elsea, *University of Northern Colorado*  
 Richard B. Griffin, *University of Tennessee at Martin*  
 Philip Kintzele, *Central Michigan University*  
 Kurtis P. Klumb, *University of Wisconsin—Milwaukee*  
 Robert M. Kozub, *University of Wisconsin—Milwaukee*  
 Susan Martin, *Grand Valley State University*  
 David J. Medved, *Detroit College of Business*  
 Dave Nichols, *University of Mississippi*  
 Donald Pagach, *North Carolina State University*  
 Heibatollah Sami, *Temple University*  
 Ali M. Sedaghat, *Loyola College in Maryland*  
 R. B. Vinson, *University of Texas at Brownsville*

We appreciate the care in preparation and proofing by our student assistants: Shelly Skrobis, Brian Sobocinski, and Alexander Wheeler.

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Dr. Fischer has previously authored *Cost Accounting: Theory and Applications* (with Frank), *Financial Dimensions of Marketing Management* (with Crissy and Mossman), journal articles, and computer software. He actively pursues research and consulting interests in the areas of leasing, pension accounting, and business combinations.

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Dr. Taylor is actively involved in the Wisconsin Institute of Certified Public Accountants and has served as their president and as a director. He is also a member of the American Institute of CPAs and the National Association of Certified Valuation Analysts. He serves as a director and officer for a number of organizations.

**Rita H. Cheng** is the A.O. Smith Teaching Professor of Accounting at the University of Wisconsin-Milwaukee. She teaches government and nonprofit accounting and advanced accounting. She also teaches in a CPA review and is often asked to speak on government and nonprofit accounting topics. She has been recognized for her teaching excellence and is a recipient of the School of Business Administration Advisory Council Outstanding Teaching Award. She earned her Ph.D. in Accounting from Temple University. She is a CPA and a Certified Government Financial Manager.

Dr. Cheng is actively involved in research focusing on the quality of accounting and financial reporting by state and local governments and the influence of accounting regulation on corporate business competitiveness. She has published numerous journal articles and technical reports. She is an active member of the Government and Nonprofit Section of the American Accounting Association. She has also testified before the Governmental Accounting Standards Board and coordinated the academic response to several proposed standards.

# PART 1

## COMBINED CORPORATE ENTITIES AND CONSOLIDATIONS

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CHAPTER 7	<i>Special Issues in Accounting for an Investment in a Subsidiary</i>
CHAPTER 8	<i>Subsidiary Equity Transactions; Indirect and Mutual Holdings</i>
SPECIAL APPENDIX 2	<i>Possible New Consolidation Procedures—Changes in Parent's Interest and Subsidiary Equity</i>
SPECIAL APPENDIX 3	<i>Leveraged Buyouts</i>

The acquisition of one company by another has become an increasingly common transaction. Recording methods have been stable for over 20 years. We are now, however, in a period of uncertainty for the accounting methods used for these transactions. There are two accounting models available for acquisitions, the purchase and pooling of interests methods. Both of these methods are under great scrutiny; major changes in their application can be expected. These changes are studied in the first two special appendices.

There are two types of transactions that can be used to secure control of another company. The first is to acquire all the assets and liabilities of a company directly from the company by paying cash or issuing securities. This is called a *direct asset acquisition*. The theory of purchase and pooling will be developed in this context in Chapter 1.

The more popular method to establish control is to purchase a controlling interest, usually over 50%, in the common stock of another company. Accounting standards hold that when two or more companies are under common control, only one set of *consolidated statements* should be prepared for the companies under common control. Chapters 2 through 8 provide the methods for consolidating separate statements of the affiliated firms into one consolidated set of consolidated statements.



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Special Appendix 1	Possible New Consolidation Procedures—Goodwill
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