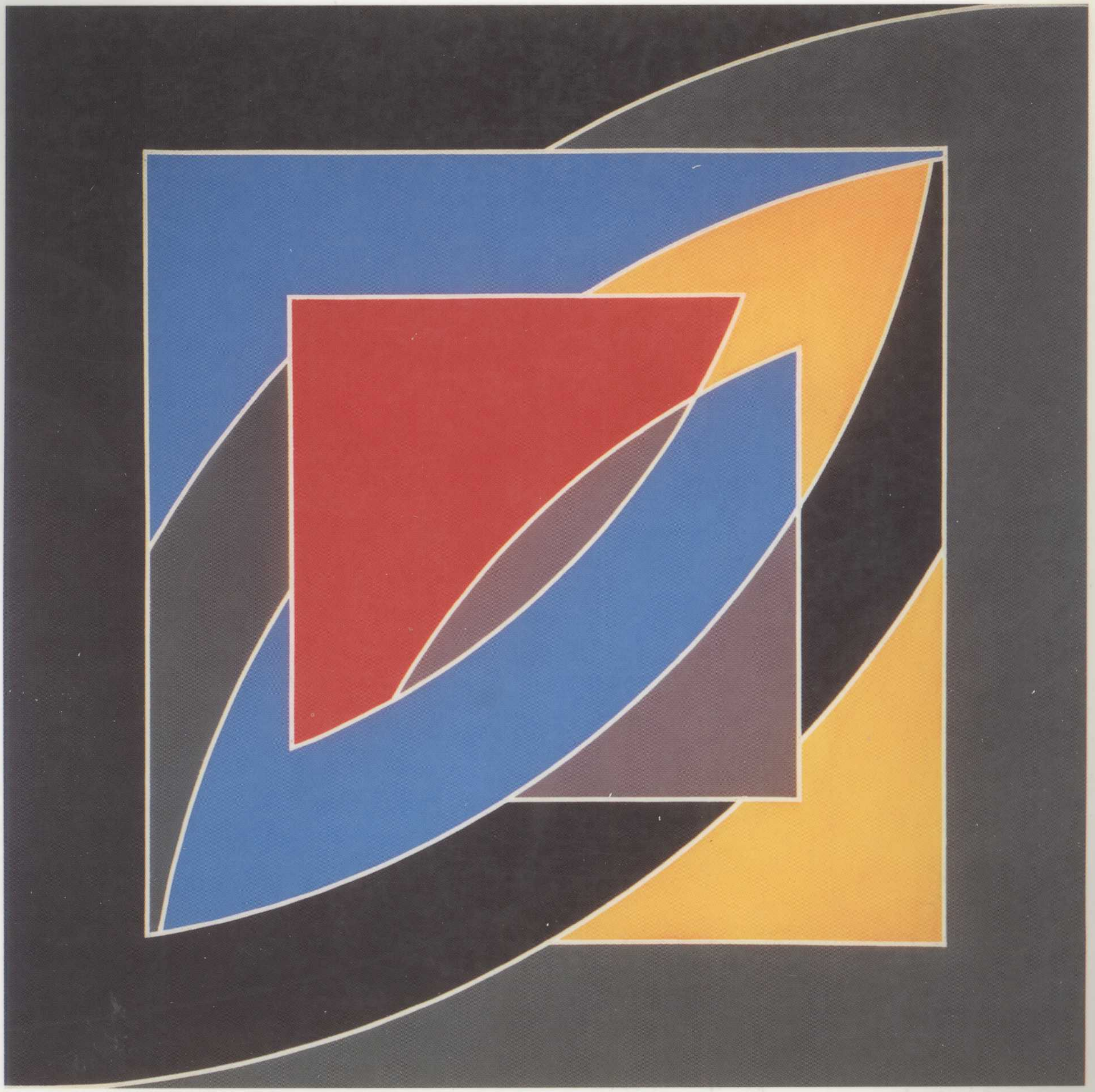
Business Combinations & International Accounting



HARTWELL C. HERRING III

BUSINESS COMBINATIONS & INTERNATIONAL ACCOUNTING

Hartwell C. Herring III
Professor of Accounting, Utica College

THOMSON
SOUTH-WESTERN

Australia · Canada · Mexico · Singapore · Spain · United Kingdom · United States

THOMSON
SOUTH-WESTERN

Business Combinations & International Accounting, 1e
Hartwell C. Herring III

Editor-in-Chief:
Jack W. Calhoun

Vice President/Team Director:
Melissa S. Acuña

Publisher:
Bill Schoof

Senior Developmental Editor:
Sara E. Wilson

Senior Marketing Manager:
Julie Lindsay

Production Editor:
Salvatore N. Versetto

Manufacturing Coordinator:
Doug Wilke

Compositor:
Navta Associates, Inc.

Printer:
West Group
Eagan, Minnesota

Design Project Manager:
Michelle Kunkler

Cover and Internal Designer:
Ellen Pettengell Design
Chicago, Illinois

Cover Painting:
©2001 Frank Stella/Artists Rights Society (ARS)
New York, New York

Media Developmental Editor:
Sally Nieman

Media Production Editor:
Lora I. Craver

Printed in the United States of America
1 2 3 4 5 04 03 02 01

For more information contact South-Western, 5191 Natorp Boulevard, Mason, Ohio 45040.
Or you can visit our Internet site at:
http://www.swcollege.com

Library of Congress Cataloging-in-Publication Data
Herring, Hartwell, C.
Business combinations and international accounting / Hartwell C. Herring, III.
p. cm.
Includes bibliographical references and index.
ISBN 0-538-87893-2 (alk. paper)
1. Consolidation and merger of corporations—Accounting. 2. Corporations—Accounting. I. Title.

HF 5686.C7 H429 2003
657'.96—dc21

2001047397

PREFACE

Accounting educators are being challenged to revolutionize curriculum structure, curriculum goals, and the relative emphasis placed on student skills as compared with student knowledge. *Business Combinations and International Accounting* provides the professor with a resource that can be used to teach a class in different ways. As key components of a course that places greater emphasis on skills development, this text covers the essential issues in business combinations and international accounting. In such an environment, this book would not be the driver of the course in the way that traditional Advanced Accounting books are written. The set of nine chapters would be used as a springboard resource in a course that includes research projects, student presentations, case studies, and role playing exercises.

Alternatively, the Advanced Accounting course can be taught using different modules to cover only those topics needed to meet the course goals. *Business Combinations and International Accounting* is one in a series of modules from which to choose. This series allows instructors the flexibility of selecting specific topics for coverage in their course. As of January, 2002, the additional modules available include *Today's Essentials of Governmental and Not-For-Profit Accounting and Reporting* by Martin and West (0-324-11164-9) and *Accounting for Partnerships* by Stokes (0-324-12098-2). Contact the publisher for information about the availability of other modules.

Key Features

Focus on Core Content: This innovative module by Hartwell Herring covers the basic principles of business combinations and international accounting in a straightforward manner. Core topics are presented step-by-step so readers can easily understand the concepts and procedures involved in business mergers and consolidations and in accounting for foreign exchange transactions and reporting.

Current Coverage: The most recent GAAP is applied to the content in this module. The FASB Statements No. 141 and 142 are clearly presented. The coverage of pooling of interests is presented in its own chapter to allow course content flexibility.

Topical Approach: Using the topical approach allows readers to develop and build upon their understanding and accounting skills as they proceed through the module.

Interpretive Exercises: Strategically placed within the body of the chapters, these exercises direct readers to apply what they have learned to a variety of situations. New data or other assumptions are provided along with specific questions to be answered. These exercises assist readers as they gradually increase their understanding of the chapter content.

Conceptual Questions and Reflection: To enhance reader understanding of the basic reasoning behind the process, the author has included questions that focus on how different accounting choices and approaches impact reported information.

Ties to the Real World: Information gleaned from business publications and from actual financial reports is used to illustrate chapter concepts and the role of accounting in the business community.

Objective-based Learning: Each chapter begins with a series of clearly-stated, measurable learning objectives that help readers focus on specific learning goals. These objectives are repeated at the beginning of the content summary.

Supporting Materials

The printed **Instructor's Resource Manual** (0-324-02383-9) presents solutions to the assignments and the complete test bank.

The **Instructor's Resource CD** (0-324-02381-2) contains the electronic files for the solutions to the assignments, the test bank, and the PowerPoint® slides for display in the classroom.

Several of these resources and other supporting content are available on the Advanced Accounting Modular Series Web site (http://advanced.swcollege.com).

Acknowledgments

Helpful feedback on the content of this text was received from several individuals throughout the development of the chapters. I extend a special thank you to all who have assisted me. In particular, I wish to acknowledge the following individuals who shared their detailed comments and suggestions:

James Chiu, California State University—Northridge
Lola Dudley, Eastern Illinois University
Donald Edwards, University of Arkansas at Little Rock
Jack Ethridge, Stephen F. Austin State University
Robert Needham, Bucknell University
James Reburn, Samford University
Charles Tritschler, Purdue University
Donald Wallin, The Ohio State University

Hartwell C. Herring, III

ABOUT THE AUTHOR

Hartwell C. Herring III is Professor of Accounting at Utica College in Utica, New York. A CPA, Dr. Herring received BBA and MS degrees from The University of Mississippi and his Ph.D. from The University of Alabama. He was also an accounting faculty member at The University of Tennessee for twenty-seven years, where he rose to the rank of Professor of Accounting. During his career, Professor Herring has published extensively, particularly on subjects related to accounting education, including articles in *Issues in Accounting Education*, *Management Accounting*, and *Journal of Accounting Education*. He has also written professionally-published continuing education materials and was co-author of the monograph, *A Framework for the Development of Accounting Education Research*, published by the American Accounting Association. His research support includes funding from the AICPA, The Haskins & Sells Foundation, The American Accounting Association, and The Coopers & Lybrand Foundation. He currently serves as an associate editor of *Accounting Education*, an international journal and has served on the editorial boards of both *Issues in Accounting Education* and *Journal of Accounting Education*.

Dr. Herring has taught all areas of financial accounting, including principles, intermediate, advanced, international, governmental accounting, and accounting for not-for-profit organizations. He is a member of the American Accounting Association, the Institute of Management Accountants, and the American Association of University Professors. During summer vacations and holidays, Dr. Herring enjoys hiking and camping with his wife Polly. He also enjoys the study of French language and culture and has traveled extensively in France.

TABLE OF CONTENTS

BUSINESS COMBINATIONS

1

A business combination occurs when two or more companies come under common ownership. This combining can occur in two ways: (1) one company can acquire all of the assets and assume all of the liabilities of another company or (2) one company can acquire a controlling interest in the outstanding common stock of another company, creating a parent-subsidiary relationship. Chapter 1 of this book explains the theory and illustrates the procedures for the first type of combination following the currently accepted **purchase method** of accounting. Accounting for the second type of business combination, the parent-subsidiary relationship, is more complex. The basic theory and practice of accounting for subsidiaries is covered in Chapters 2 through 7. Since subsidiary ownership involves an investment in common stock, Chapter 2 reviews accounting for common stock investments, particularly the procedures for applying the equity method of accounting. Chapters 3 through 6 explain the theory and practice of preparing consolidated financial statements for a parent company and its subsidiaries where the subsidiary was also acquired using the purchase method of accounting. In July 2001, the Financial Accounting Standards Board finalized rules that make the purchase method of accounting the only acceptable method for all business combinations. However, a second method of accounting for business combinations, called the **pooling of interest method**, was used for many business combinations until very recently. Chapter 7 explains how this method affects the balance sheet and results of operations of both types of business combinations. While not permitted under current accounting rules, the pooling of interest method of accounting will continue to affect financial reporting as long as subsidiaries acquired using this accounting method are owned.

CHAPTER 1

BUSINESS COMBINATIONS INVOLVING THE MERGER OR CONSOLIDATION OF NET ASSETS

LEARNING OBJECTIVES

- Explain the business and economic incentives for business combination transactions
- Describe the two basic types of business combinations
- Account for mergers/consolidations using the purchase method
- State the financial statement disclosures required for purchase method mergers/consolidations

THE BUSINESS AND ECONOMIC INCENTIVES FOR BUSINESS COMBINATIONS

On December 16, 1996, the headlines in *USA Today* announced, "Aerospace Giants to Merge." The related articles went on to describe how The Boeing Company and McDonnell Douglas Corporation planned to form a single company in an arrangement whereby Boeing would acquire $13.3 billion of McDonnell Douglas stock. The plan called for McDonnell Douglas shareholders to receive .65[1] shares of Boeing common stock in exchange for each share of McDonnell Douglas common stock. This merger agreement, which was completed in July 1997, created a major corporation in the defense industry, rivaling Lockheed-Martin in size. It left only two companies in the world in the business of manufacturing large commercial jetliners. The remaining competitor is Airbus Industrie, a consortium of companies in Great Britain, France, Germany, and Spain. During the decade of the 1990s, the combined Boeing-McDonnell Douglas had an average market share of about two-thirds of the total worldwide market for large commercial jetliners. The addition of McDonnell Douglas defense contracts also greatly increased Boeing's penetration into that segment of the aerospace industry.

The decision to proceed with a business combination is affected by both positive and negative events. Both types of events were apparent in the Boeing-McDonnell Douglas plan. After a defense department review of initial proposals, Boeing and Lockheed-Martin were the two remaining companies competing for the U.S. Military $350 billion joint strike fighter contract. Boeing will benefit from McDonnell Douglas's expertise in competing for this contract. McDonnell Douglas, on the other hand, was no longer in a strong position to remain independent in a shrinking defense market, having been eliminated by the defense department as a potential contractor for a large military contract. Moreover, its share of the large commercial jetliner market was less than 5% of the total worldwide market. By combining, these companies hoped to reduce the risks associated with doing business because the new combined entity would be more diverse than either company was separately.

This example demonstrates that business combinations are undertaken for a variety of legitimate business reasons and that several reasons usually exist for any particular situation. In a business environment where competitive forces are constantly changing, the ability to form new companies from existing ones is an efficient way for companies to adjust to these forces, allowing all stakeholders to ultimately benefit. Following is a summary of some of the important motivations for forming business combinations, including those apparent in the above example.

- Horizontal and vertical integration—Horizontal integration involves combining with companies in the same line of business. Recent examples include combinations in the communications industry such as the Bell Atlantic-NYNEX[2] combination in 1996. The core business of these two companies is telephone communications. As the communications industry becomes more deregulated, industry analysts expect further consolidation of telephone services throughout the United States. Vertical integration involves acquisition of companies that serve as suppliers to or customers of the acquiring company. Vertical integration is common in many industries. An excellent example is the petroleum industry, where all the major companies have operations in three vertically related segments—exploration and production, refining, and marketing.

[1] This exchange ratio was later revised to 1.3 shares of Boeing for each share of McDonnell Douglas when Boeing stock was split two for one prior to the date the acquisition became final.

[2] Bell Atlantic changed its name to Verizon Corporation in 2000.