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Advanced Financial Accounting

Sixth Edition



Richard E. Baker

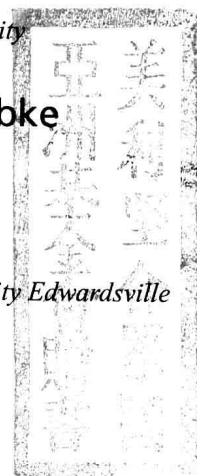
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Advanced Financial Accounting

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Richard E. Baker is the Ernst & Young LLP Distinguished Professor of Accountancy at Northern Illinois University. He has been recognized as an inaugural University Presidential Teaching Professor, the highest teaching recognition of his university. He received his B.S. degree from the University of Wisconsin—River Falls and his MBA and Ph.D. from the University of Wisconsin—Madison. His activities in the American Accounting Association include serving as the Director of Education, Chair of the Teaching and Curriculum Section, and President of the Midwest Region. His service to the Federation of Schools of Accountancy includes serving as President, Vice President, and Secretary. Many of his committee service efforts have involved research in assessing teaching and learning outcomes, as well as promoting the integration of computing into the accounting classroom. Professor Baker served as an Associate Editor for *Issues in Accounting Education* and previously served for several years as a reviewer for this journal. He has served as an Associate Editor of *The Journal of Accounting Education* and as a reviewer for *Accounting Education*, *Accounting Horizons*, and *Advances in Accounting Education*. He has received numerous teaching awards at both the undergraduate and graduate levels and was selected as the Illinois CPA Society's 1993 Outstanding Accounting Educator. In 2002, he was selected as one of the first two recipients of the American Accounting Association's Teaching and Curriculum Section's Distinguished Achievement Award. His most recent published research studies have concentrated on ways to make the learning/teaching experience as effective as possible. Other published research includes studies in financial reporting and in mergers and acquisitions. Professor Baker's major teaching areas are advanced financial accounting, financial theory, and international business. A CPA, he also teaches advanced financial accounting topics in CPA Examination review courses.

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Preface

The sixth edition of *Advanced Financial Accounting* is a comprehensive and highly illustrated presentation of the accounting and reporting principles used in a variety of business entities. Every day, the business press carries stories about the possible rebirth of the 1990s merger and acquisition mania, the complexities of modern business entities and 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 other topics typically included in advanced accounting. Accountants must know how to deal with the accounting and reporting ramifications of these issues.

OVERVIEW

The sixth edition of *Advanced Financial Accounting* continues to provide a strong presentation of advanced accounting topics, clear discussion, and integrated coverage based on continuous case examples. The text is highly illustrated with complete presentations of worksheets, schedules, and financial statements so that students can see the development of each topic. Inclusion of all recent FASB and GASB pronouncements and the continuing deliberations of the authoritative bodies provides a current and contemporary text for students preparing for the CPA Examination and current practice. Reflecting current developments in the business world, new forms of ownership and control are discussed. In the chapters covering consolidation subsequent to the date of combination, three alternative methods of accounting for the parent's investment in the subsidiary are presented in each chapter (basic equity) and appendices (cost and fully adjusted equity) to provide the opportunity for exploring the differences in the methods and seeing that the consolidated financial statements are the same regardless of the method the parent company uses to account for the investment. The chapters dealing with global operations include a comprehensive discussion of accounting for foreign currency derivatives and other financial instruments and arrangements used in today's business arena. The governmental and not-for-profit chapters include all recent important pronouncements and developments in those areas.

KEY FEATURES

The key strengths of this book are the clear and readable discussions of concepts and the detailed demonstrations of these concepts through illustrations and explanations. The many favorable responses to earlier 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 of the sixth edition include:

- **A building-block approach based on a strong conceptual foundation.** For each major topic area, students are provided a thorough conceptual discussion before advancing to the procedures. The discussion begins with the fundamental concepts and reasons that they are important. These fundamentals are then illustrated, giving students a basic example before progressing. Once this conceptual foundation is established, the complexities are layered gradually in successive steps. The authors developed this methodology through years of teaching the course. Many adopters have commented favorably on the effectiveness of this approach.
- **The use of a continuous case for each major subject-matter area.** The comprehensive case of Peerless Products Corporation and its subsidiary, Special Foods, Inc., has been continued in the for-profit chapters. For the governmental chapters, the Sol City case has been used to facilitate the development of governmental accounting and reporting concepts and

procedures. Using a continuous case provides several benefits. First, students need 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 the financial reports of a company. 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 basic equity method of accounting for an investment in a subsidiary, but two other methods—the cost method and the full adjusted equity method—are discussed and illustrated fully in chapter appendices. Workpaper entries presented in the consolidations chapters are separately identified with an (E) and are shaded to differentiate them clearly from book entries. The extensive use of illustrations makes the learning process more efficient by allowing students to see quickly and readily the applications of the concepts. In addition, the illustrations reinforce understanding of the concepts by demonstrating the effects on the financial statements. In this manner, students understand that the many workpaper procedures typically covered in advanced accounting are the means to a desired end, not the end themselves.
- **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, the 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 opportunities to go into greater depth on some topics through the use of the “Additional Considerations” sections. Several chapters include appendices 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 provides 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 and for gaining exposure to different sources of accounting-related information. Additional end-of-chapter materials have been added based on the expectations for the computerized CPA examination, including questions and cases related to the FARS database in which students are asked to search for and reference relevant accounting standards.

ORGANIZATION: THE STORY OF PEERLESS PRODUCTS CORPORATION AND SPECIAL FOODS, INC.

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. In this edition, discussions tied to the case are easily identified by the company logos in the margin:



The following sections describe how the text is organized and how the company story unfolds to demonstrate many of the topics.

Business Combinations, Intercorporate Equity Investments, and Consolidation Concepts

Chapters 1 and 2 of the textbook introduce the issues associated with the development of multientity structures through business combinations and other forms of ownership and control. Chapter 3 provides a conceptual foundation for the study of consolidated financial statements.

Consolidation at Date of Combination

Chapter 4 initiates the story of Peerless Products Corporation, which purchases the stock of Special Foods, Inc. and maintains Special Foods as a subsidiary. Basic consolidation procedures are presented, and the preparation of a consolidated balance sheet as of the date of combination is illustrated for Peerless Products and Special Foods.

Consolidation Subsequent to Combination

Chapter 5 continues the development of Peerless Products and Special Foods through the first two years of combined operations. This chapter introduces the three-part consolidation workpaper and considers the procedures used to develop a complete set of consolidated financial statements for the combined entity.

Intercompany Transactions

As is common for affiliated companies, Peerless and Special Foods engage in a number of intercompany transactions. Chapters 6, 7, and 8 discuss intercorporate transfers of noncurrent assets, intercompany inventory transactions, and intercompany indebtedness, respectively.

Complex Ownership Issues

Chapter 9 examines the special consolidation problems that arise from complex ownership structures. Included are the accounting issues that arise if (1) Special Foods issues preferred stock, (2) Peerless decreases its percentage of ownership in Special Foods by selling some of its stock investment to a party outside the consolidated entity or increases its ownership percentage by acquiring additional stock of Special Foods, (3) Special Foods purchases a subsidiary of its own, (4) Special Foods acquires some of Peerless Products' stock, and (5) Special Foods issues stock dividends.

Consolidation Reporting Issues

Chapter 10 completes the discussion of consolidated reporting by presenting several additional consolidation issues encountered by Peerless and Special Foods. First, the preparation of a consolidated cash flow statement is discussed and illustrated for Peerless Products and Special Foods. Second, the impact of interim acquisitions on consolidated financial statements is examined. Third, the chapter discusses tax considerations related to consolidated entities. The chapter concludes with a discussion of the computation of consolidated earnings per share.

Multinational Accounting

Chapters 11 and 12 present the accounting and reporting issues that arise when Peerless enters the multinational business environment. First, Peerless extends its sales to international customers and begins dealing in foreign currency transactions. To manage its risk, Peerless uses forward exchange contracts and other financial derivatives for hedging purposes. The chapter's comprehensive appendices discuss using the time value of derivatives and accounting for other forms of derivatives. In Chapter 12, Peerless acquires a subsidiary located in Germany. The German company reports its operations in euros, and Peerless must translate the subsidiary's trial balance into U.S. dollars to consolidate the operations of its German subsidiary.

Segment and Interim Reporting

Chapter 13 discusses segment reporting requirements and examines the segment and related disclosures that Peerless must make in its consolidated financial statements. Interim financial reporting also is discussed in this chapter and is illustrated with Peerless's interim reports.

SEC Reporting

Chapter 14 discusses the issues that Peerless must understand if it wishes to "go public" and issue stock or debt in the capital markets. The Securities and Exchange Commission has many specific rules, procedures, and reporting requirements that companies must follow if their securities are going to trade publicly.

Partnership Accounting

Chapters 15 and 16 step back in chronology to review the origins of Peerless Products. The process begins with C. Alt starting a software development business. Alt then forms a partnership with Blue, and, after operating for a year, the two partners bring Cha into the partnership because they need her business expertise. Accounting issues associated with partnership accounting are presented in these two chapters. After operating the partnership for several years, the partners incorporate their business under the name Peerless Products Corporation.

Governmental and Nonprofit Accounting

Chapters 17 and 18 present the accounting and financial reporting for Sol City, the city in which Peerless Products is located. C. Alt serves on the city council, and the chapters present the accounting information Alt needs to represent his constituents. Chapter 19 presents the accounting and financial reporting requirements for Sol City University and for Sol City Community Hospital along with several other nonprofit agencies in Sol City.

Corporations in Financial Difficulty

Chapter 20 closes the story of Peerless Products and Special Foods. Because of the poor health of C. Alt, the consolidated entity experiences a variety of financial problems. Attempts are made to restructure its debt and to reorganize with the help of a court-appointed receiver. However, the company has too many financial problems and is forced to enter into bankruptcy.

Supplemental Chapters

The text's Website at www.mhhe.com/baker6e contains two supplemental chapters. The first, Accounting for Branch Operations, presents illustrations and discussion on the issues of accounting for home offices and branches. The second supplemental chapter, Estates and Trusts, presents the accounting for C. Alt's estate by Blue, the administrator of the estate and the first

person brought into the Peerless Products partnership. These chapters include end-of-chapter materials for which instructors may obtain solutions from the text's Website.

CHANGES FOR THE SIXTH EDITION

Each of the chapters in the text has been revised to include comprehensive discussion and full illustration of relevant FASB and GASB standards. In addition, end-of-chapter materials have been developed and added to best illustrate and explore these new standards.

1. The chapter on business combinations reflects the FASB's elimination of pooling of interests as a method of accounting for business combinations. Pooling is discussed briefly because the effects of prior poolings will affect financial statements for years to come. The treatment of goodwill subsequent to a business combination, including the measurement of any impairment, is discussed and illustrated. The FASB's continued deliberations and refinements relating to business combinations and intangibles are also discussed.
2. Because many business enterprises create other business units to meet their goals rather than purchase existing companies, a section on created subsidiaries has been added and material on created subsidiaries has been integrated in the text. Discussion on investments in unincorporated business units has also been added.
3. Because of the importance, and notoriety, of special-purpose entities (SPEs) in recent years, coverage of this important topic has been added. Discussion of the FASB's recent interpretation relating to variable interest entities (VIEs) is included and illustrated.
4. The consolidation materials include discussion and illustration of the consolidation of VIEs, as well as discussion of the FASB's current deliberations on important consolidation issues such as the treatment of noncontrolling interests and full recognition of fair values and goodwill (entity approach).
5. End-of-chapter assignment material has been enhanced with additional cases, exercises, and problems while maintaining the best of the end-of-chapter materials from the fifth edition. Assignment material focusing specifically on new accounting issues and standards has been added. In addition, assignment material has been added to reflect the coverage on the new-format CPA Examination. End-of-chapter cases have been classified based on the set of skills accepted by the American Institute of CPAs' Board of Examiners (BOE) as being needed by entry-level CPAs. These skills will be tested specifically on the CPA Examination. The skill definitions accepted by the BOE and used in identifying the end-of-chapter cases in this text are as follows.¹
 - *Analysis* is the ability to organize, process, and interpret data to develop options for decision making.
 - *Judgment* is the ability to evaluate options for decision making and provide an appropriate conclusion.
 - *Communication* is the ability to effectively elicit and/or express information through written or oral means.
 - *Research* is the ability to locate and extract relevant information from available resource materials.
 - *Understanding* is the ability to recognize and comprehend the meaning and application of a particular matter.

¹ Board of Examiners of the American Institute of Certified Public Accountants, "Skills for the Uniform CPA Examination," April 14, 2003, http://www.cpa-exam.org/download/CBT_skills_weights_final.pdf.

One of the listed skills will be noted in the margin next to each end-of-chapter case to identify the primary skill required in completing it. Many cases require application of multiple skills, but only the primary skill is identified in the margin.

6. Chapter 11, Multinational Accounting: Foreign Currency Transactions and Financial Instruments, has been extensively revised and extended to include additional presentation of the accounting and reporting of derivative and hedging transactions. Instructors have indicated the increasing importance of this topic for advanced financial accounting courses.
7. The governmental accounting chapters have been revised to include recent GASB pronouncements on disclosure of budgetary information (**GASB No. 41**), management's discussion and analysis, and other financial statement disclosures. Additional other-objective-answer-format (OOAF) exercises and problems have been added to reflect the coverage of governmental accounting on the CPA examination.
8. Coverage of the Sarbanes-Oxley Act has been added to the SEC chapter.

RETAINED FEATURES

The features that provided the strength of earlier editions have been retained in the sixth edition:

1. The comprehensive continuous case approach has been retained because it provides students the ability to see how each successive step affects the financial reporting model of an entity. The Peerless Products and Special Foods case is robust and serves as a foundation for the building-block approach used throughout the text.
2. Although each chapter has been revised to some extent to reflect recent FASB and GASB standards and to refine and focus the discussion and presentations, extensive efforts were made to ensure retention of the clear writing style that faculty and students have valued very highly in previous editions.
3. The full coverage of the FASB and GASB standards that have direct applicability to the topics in advanced financial accounting has been maintained.
4. Cases at the end of each chapter requiring students to write essay-type responses reflecting alternative viewpoints or justifying a specific accounting choice have been retained and updated. Students are asked to explain their reasoning and often must use library or Internet research tools and materials to support their answers. These cases require students to go beyond the computational level in addressing the topics in advanced financial accounting.
5. The end-of-chapter materials have been enhanced while retaining the wide variety of assignment materials for which the text is known.
6. The Internet-based cases and exercises introduced in the fifth edition have been enhanced to provide students additional opportunities to access real-world data sources in conjunction with their coverage of the topics and to prepare for the new-format CPA Examination.
7. The study guide for the text is written by the text authors to ensure full integration and compatible presentation of the topics. The study guide for the sixth edition has been extensively revised to reflect all updates and enhancements in the textbook coverage as a result of the new GASB and FASB standards, and every effort has been made to provide a terrific learning tool for students.
8. Because the advanced financial accounting course is often taken by students who plan to take the CPA Examination, numerous end-of-chapter materials are provided in the formats used for testing on the CPA Examination. A wide variety of multiple-choice questions, cases requiring written presentations and database research, and other objective answer format (OOAF) materials is provided.

SUPPLEMENTS

This text is accompanied by a full ancillary program with items designed to enhance the learning process. Supplemental materials are available from McGraw-Hill/Irwin.

For the Student

Study Guide (ISBN: 0072866349).

Prepared by the text authors and closely coordinated with the text, the study guide contains summaries of the key concepts presented in each chapter and provides self-diagnostic and review materials in the form of objective-type and fill-in-the-blank questions as well as both short and comprehensive exercises and problems. The solutions are provided so that achievement levels can be assessed readily and topics that need further review can be identified.

Online Learning Center (URL: www.mhhe.com/baker6e), Student Edition.

- *Online Quizzes*: Prepared by Lisa Enfinger, interactive quizzes give students a variety of multiple-choice and true/false questions related to the text for self-evaluation.
- *Accounting Workpapers*: Created by the text authors, accounting workpapers provide useful forms for solving many of the end-of-chapter problems in the text. To increase efficiency, the forms already contain trial balances, other opening data, and column headings. Available only online.
- *Excel Worksheets*: Prepared by Harlan Fuller, Illinois State University, these worksheets for use with Excel are provided to facilitate completion of problems requiring numerous mechanical computations. Available only online.
- *Check Figures*: Prepared by the text authors, a list of answers is provided separately for many of the end-of-chapter materials in the text. Available only online.
- *Microsoft PowerPoint Slides®*: Authored by Michael Luehlhing, copies of the Microsoft PowerPoint Slides® are available by chapter to facilitate note taking and review.
- *PowerWeb*: This feature is a unique Website that extends the learning experience beyond the core textbook itself and includes the following learning aids:
 - Current readings with assessments
 - Study tips and self-quizzes
 - Links to related sites
 - Web research guide
 - Access to Northern Light Search Engine providing Internet access to additional articles

For the Instructor

Instructor's Resource CD-ROM (ISBN: 0072866357).

Only for instructors, this CD combines all instructor resource teaching supplements into one easy to use format:

- *Solutions Manual*: Created by the text authors, solutions are provided for all questions, cases, exercises, and problems in the text. Solutions are carefully explained and logically presented. Answers to many of the multiple-choice questions include computations and explanations. Instructors can prepare transparencies directly from the solutions manual.
- *Instructor's Resource Manual*: Prepared by Marianne James, California State University, Los Angeles, the instructor's resource manual includes chapter outlines, additional examples, teaching suggestions, and other materials to assist instructors in making the most effective use of the text.

- *Test Bank*: Authored by Dr. G. Eddy Birrer of Gonzaga University, this comprehensive collection of both conceptual and procedural test items has been revised. The material is organized by chapter and includes a large variety of multiple-choice questions, exercises, and problems that can be used to measure student achievement in the topics in each chapter. The test items are closely coordinated with the text to ensure consistency. This test bank is also provided in a computerized format.
- *Microsoft PowerPoint Slides®*: Created by Michael Luehlfiging, a PowerPoint presentation accompanies each chapter in the text.

Online Learning Center (URL: www.mhhe.com/baker6e), Instructor Edition.

- Instructor supplements such as the Solutions Manual, Instructor's Resource Manual, and Microsoft PowerPoint Slides® are available in downloadable form and are password protected.
- PowerWeb delivers to instructors and students the latest news and developments pertinent to the course.
 - Access to current articles related to advanced financial accounting
 - Daily and weekly updates with assessment tools
 - Links to related sites
 - Web research guide
 - Access to Northern Light Search Engine providing Internet access to additional articles
- Online Course Support provides course content cartridges available for course Websites to support on-line class delivery when using products such as WebCT or Blackboard.
- PageOut is McGraw-Hill's Course Management System that provides a "point and click" course Website tool.

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Richard E. Baker

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