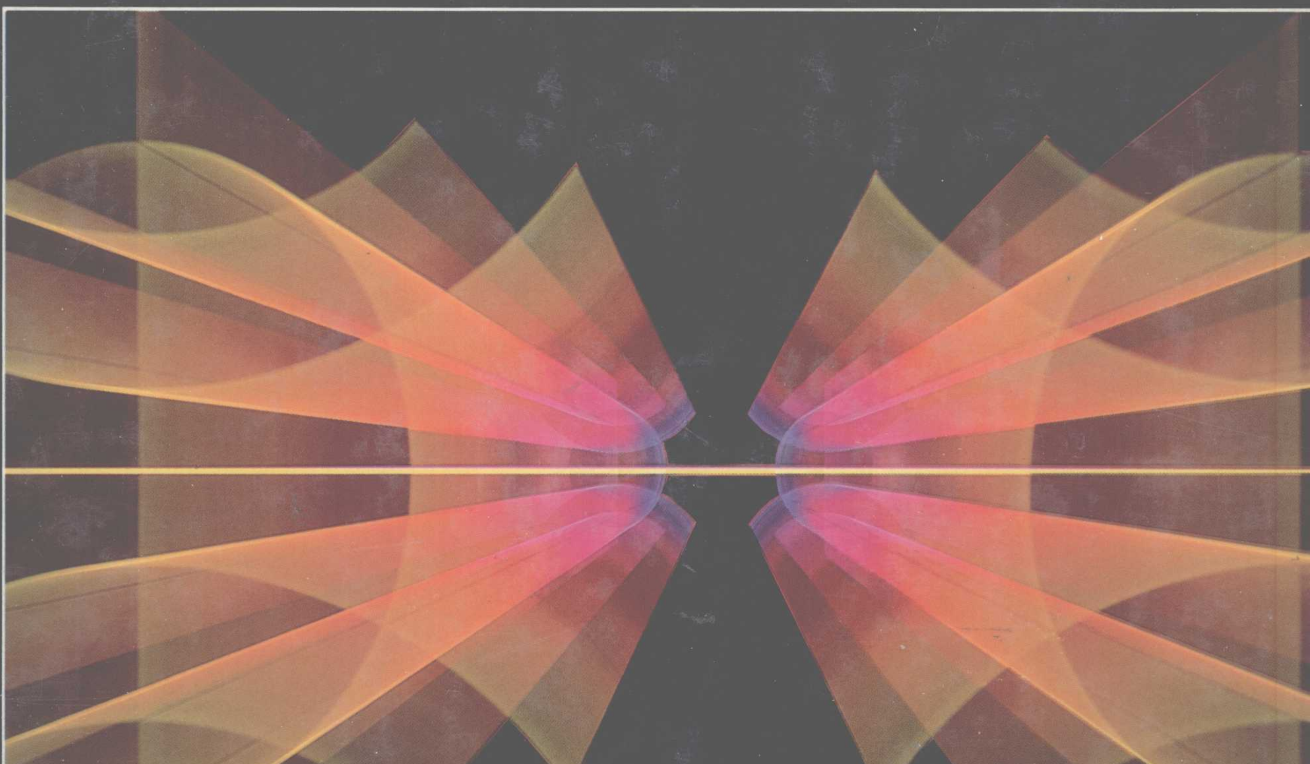
ADVANCED ACCOUNTING

FOURTH EDITION



FLOYD A. BEAMS

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Fourth Edition

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Preface

This fourth edition of *Advanced Accounting* contains twenty-one chapters and is designed for financial accounting courses above the intermediate level. The chapters have been updated for recent business developments and for changes in accounting standards and legal and regulatory requirements. Many of the chapters have also been revised for better sequencing, more efficient coverage, and improved readability. These changes are the result of many valuable suggestions that I received from users and reviewers of earlier editions.

An important feature of this book lies in its student orientation, and special effort has been expended to maintain it in this 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 that is designed to provide variety and maintain student interest. The text also includes a number of exhibits that describe complex material in summary form to reinforce and clarify important points. All assignment material, including items from past CPA Examinations, is closely aligned with chapter coverage. Names of parent and subsidiary companies begin with P and S for convenient identification and reference.

Several important changes have been made in this fourth edition of *Advanced Accounting*. These are:

- Consolidation of pooled subsidiaries is integrated into the consolidation chapters rather than being covered in a separate chapter.

- Foreign currency transactions and financial statements are now presented in separate chapters. Earlier editions combined these topics in a single chapter.
- The consolidated statement of cash flows together with worksheet illustrations and assignment material is integrated into the consolidation and foreign entity chapters.
- A new section on push-down accounting with illustrations and problem material has been added in Chapter 11.

ORGANIZATION

The first eleven chapters cover business combinations, the equity method of accounting as a one-line consolidation, and consolidated financial statements. This emphasis reflects the increasing importance of consolidations in advanced accounting courses as well as in financial accounting and reporting practices.

Accounting standards for business combinations are covered in Chapter 1, along with applicable accounting and reporting standards. Chapter 1 also provides relevant background material relating to the form and economic impact of business combinations.

The equity method of accounting as a one-line consolidation is introduced 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 doing something different.

While the book establishes the one-line consolidation as the standard of parent company accounting for its subsidiaries, it does not ignore situations in which the parent company uses the cost method or a simple equity method of accounting. These methods are illustrated in the text and included in assignment material so that students will be prepared for consolidation assignments regardless of the method used by the parent company in accounting for its subsidiary investments.

Consolidated financial statements including the consolidated statement of cash flows (SCF) are introduced in Chapter 3. Coverage of the consolidated SCF has been expanded in this edition to include a "T" account worksheet approach. The consolidated SCF is included in problem material in Chapter 3 and subsequent chapters on consolidations, including Chapter 14 that covers consolidations of foreign subsidiaries. Similarily, accounting and reporting matters related to pooled subsidiaries are integrated into Chapters 3 through 11, rather than being confined to a single chapter as in prior editions.

Intercompany transactions involving inventories, plant assets, and bonds are covered in Chapters 5, 6, and 7. These chapters include a number of changes for better organization and more efficient coverage. Chapter 8 covers changes in ownership interests and has been revised to include mid-year poolings and gain recognition from subsidiary stock issuance under SEC Staff Acounting Bulletin No. 51. Consolidation of subsidiaries with preferred stock has been moved to Chapter 11 for more balanced coverage.

Chapters 9 through 11 cover complex affiliation structures, subsidiary preferred stock, consolidated EPS and income taxation, and consolidation theories, respectively. Chapter 10 has been updated for recent tax law changes and related accounting standards, and Chapter 11 on consolidation theories includes a discussion on leveraged buyouts in general and an illustration of push-down accounting. Problem material has been expanded. Since these three chapters cover special topics, their coverage is not essential background for assignment of subsequent chapters.

Chapter 12 covers branch accounting and reporting practices, 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 quite compatible with those for consolidations.

Chapters 13 and 14 cover foreign currency transactions and foreign currency financial statements. These topics were included in a single chapter in prior editions but the growing importance of multinational enterprises and the natural division of the topics led to expanded coverage in two chapters in this edition. Chapter 15 covers disclosures for industry segments.

The last six chapters of the book include two chapters on partnerships (Chapters 16 and 17), a chapter on corporate liquidations, reorganizations, and debt restructurings (Chapter 18), two chapters on governmental accounting (Chapters 19 and 20), and a final chapter that introduces the students to accounting for colleges and universities, hospitals, and voluntary health and welfare organizations (Chapter 21). GASB Statements 1 through 7 have been integrated into Chapters 19 and 20. Additional GASB Statements are expected within the next year or two.

SUPPLEMENTARY MATERIALS

The supplementary materials include both a Solutions Manual and an Instructor's Resource Manual. The Solutions Manual contains answers to questions and solutions to exercises and problems. It is developed with convenient tear-out pages for preparing transparencies. The Instructor's Resource Manual includes problem descriptions with estimated solution times; brief outlines of relevant accounting pronouncements, class illustrations, and various other lecture aids; a plentiful supply of examination material; and student check figures for problems. Partially completed working papers are available for adopters who want to use them, and spreadsheet templates using the Twin™ (a Lotus® 1-2-3® clone) are available for those who prefer personal computer applications.

ACKNOWLEDGMENTS

Many people have made valuable contributions to this fourth edition of *Advanced Accounting* and I am happy to recognize their contributions. I am indebted to the many users of prior editions for their helpful comments and constructive criticism. I also acknowledge the help and encouragement that I received from my students at Virginia Polytechnic Institute and State University who, often unknowingly, participated in class testing of various sections of the manuscript.

My sincere appreciation is extended to the following reviewers for their thoughtful comments and valuable suggestions: James Chiu, California State University, Northridge; Gary M. Cunningham, Virginia Polytechnic Institute and State University; Manson P. Dillaway, New Mexico State University; Bernard H. Newman, Pace University; Lola Rhoades, University of Texas at Arlington; Joanne Rockness, North Carolina State University; Saleha Khumawala, University of Houston; Jane Mutchler, Ohio State University; and Robert Bowman, University of Oregon.

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Contents

Business Combinations

1

A *business combination* involves the union of business entities. The uniting of 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. Although the overriding objective of business combinations must be profitability, the immediate concern of many combinations is with operating efficiencies through horizontal or vertical integration of operations, or diversification of business risks through conglomerate operations.

Horizontal integration involves the combination of firms in the same business lines and markets. Burroughs Corporation's acquisition of Sperry Corporation, both makers of large computer systems, created a new entity renamed Unisys Corporation that displaced Digital Equipment Corporation as the computer industry's second largest concern, behind IBM. *Vertical integration* involves combining firms with operations in different, but successive, stages of production and/or distribution. The purchases by PepsiCo Inc. and Coca-Cola Company of their independent bottlers to take control of critical distribution markets are examples of vertical integration. *Conglomeration* involves combining firms with unrelated and diverse products and/or service functions. The purchase of General Foods by Philip Morris Cos., Inc. and the acquisition of Nabisco Brands by R. J. Reynolds Industries, Inc. (renamed RJR Nabisco Inc.) are examples of conglomeration.

Federal laws do, of course, prohibit combinations that would be in restraint of trade or would impair competition. Proposed business combinations are scrutinized by governmental agencies such as the Justice Department, the

Federal Trade Commission, the Federal Reserve Board, and the Securities and Exchange Commission, and many are found to be in violation of federal law. For example, a proposed acquisition of Dr. Pepper Co. by Coca-Cola Co. and a proposed acquisition of Seven-Up Co. by PepsiCo, Inc. were opposed by the Federal Trade Commission because the acquisitions could unfairly limit competition in the distribution and sale of carbonated soft drinks in the United States. When antitrust objections are made to a proposed business combination, the objections may be settled through negotiation with the appropriate federal agency, or the agency may argue its case in court with a federal judge rendering the final decision as to its acceptability.

IMPACT OF BUSINESS COMBINATIONS

Several periods of merger-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. The boom period beginning in the mid-1970s survived double-digit inflation, depression, and soaring interest rates. It may have endured because acquisitions are now an integral factor in planning business expansion. The boom years of the 1980s are sometimes referred to as the restructuring period, with mergers, as well as other restructurings including recapitalizations, leveraged buyouts, large corporate buybacks of their own stock, and divestitures, contributing to record-high stock prices. By late 1986, many corporations were rushing to complete transactions before certain provisions of the Tax Reform Act of 1986 became effective. For the economy as a whole, however, mergers reshuffle the ownership of corporate assets without increasing the nation's supply of productive resources.

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. But dissolution of the acquired company is not necessary in order to have a business combination or an acquisition.

In a generic sense, the terms *merger* and *consolidation* are often used as synonyms for business combinations and acquisitions, although there is a technical difference. *Merger* in a technical sense refers to a business combination in which one corporation takes over all the operations of another business entity and that entity is dissolved and goes out of existence. A *statutory merger* occurs when the acquired company is dissolved pursuant to the laws of its state of incorporation. Thus, Company A may purchase 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, but it is not a merger unless Company B is dissolved and 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. Such an acquisition will give Company A operating control over Company B's assets, but 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* in a technical sense 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. A *statutory consolidation* refers to the dissolution of the previously separate entities under the laws of their states of incorporation. For example, Company A, a newly formed corporation, may acquire the net assets of Companies B and C by issuing stock directly to Companies B and C. In this case, Companies B and C may continue to hold Company A stock for the benefit of their stockholders (an acquisition), or they may distribute the Company A stock to their stockholders and go out of existence (a consolidation). In either case, Company A acquires ownership of the assets of Companies B and C. Alternatively, Company A could have issued its stock directly to the stockholders of Companies B and C in exchange for a majority of their shares. In this case, Company A controls the assets of Company B and Company C, but it does not obtain legal title unless Companies B and C go out of existence. Company A must acquire all the stock of Companies B and C and dissolve those companies if the business combination is to be a consolidation. If Companies B and C are not dissolved, Company A will operate as a *holding company* and Companies B and C will be its *subsidiaries*.

Future reference in this chapter will use the term *merger* in the technical sense of a business combination in which all but one of the combining companies are dissolved and go out of existence. Similarly, the term *consolidation* will be used in its technical sense to refer to a business combination in which all the combining companies are dissolved and a new corporation is formed to take over their net assets. *Consolidation* is also used in accounting to refer to the accounting process of combining parent and subsidiary financial statements, such as in the expressions "principles of consolidation," "consolidation procedures," and "consolidated financial statements." In future chapters, the meanings of the terms will depend upon the context in which they are found.

REASONS FOR BUSINESS COMBINATIONS

If one accepts expansion as a proper goal of business enterprise, the question arises as to why businesses expand through combination rather than by construction of new facilities. Some of the many possible reasons for electing business combination as the vehicle for expansion are as follows:

Cost Advantage It is frequently less expensive for a firm to obtain needed facilities through combination than through construction. This has been particularly true in recent years as inflation has pushed up the cost of new plants and equipment.

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.

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 and expensive 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 in order 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, 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.

Acquisition of Intangible Assets Business combination involves the combining of intangible, as well as tangible, resources. Thus, the acquisition of patents, mineral rights, or management expertise may be a primary motivating factor in a particular business combination.

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 various personal reasons.

THE ACCOUNTING CONCEPT OF A BUSINESS COMBINATION

The accounting concept of a business combination is reflected in *Accounting Principles Board (APB) Opinion No. 16*, which became effective on November 1, 1970. According to the Accounting Principles Board:

> A business combination occurs when a corporation and one or more incorporated or unincorporated businesses are brought together into one accounting entity. The single entity carries on the activities of the previously separate, independent enterprises.[1]

Note that the accounting concept of a business combination emphasizes the *single entity* and the *independence of the combining companies* prior to their union. Although one or more of the combining companies may lose their separate legal identities, dissolution of the legal entities is not necessary within the accounting concept.

Previously separate businesses are brought together into one entity when their business resources and operations come under the control of a single management team. Such control within one business entity is established in

[1] *APB Opinion No. 16*, "Business Combinations," paragraph 1.