

# Advanced Accounting

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*Floyd A. Beams*

# *Advanced Accounting*

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## *Preface*

This textbook is intended for students who have completed intermediate-level courses in accounting. It covers those topics most included in advanced accounting courses, but with special emphasis on consolidated financial statements. This emphasis reflects the importance of consolidations in advanced accounting courses as well as in financial accounting and reporting practices. Other major topics include branch accounting, foreign transactions and financial statements, segment reporting, partnership accounting, and financial accounting and reporting for local governmental units.

Special effort has been expended to make this book a student-oriented textbook. This effort includes the shading of working paper entries whenever they are presented in general journal form, and illustrating consolidation working papers on single, upright pages whenever feasible. The assignment material is closely aligned with the related chapter coverage and new concepts are introduced one at a time. An effort has been made to keep the chapters reasonably consistent in length and to avoid overwhelming the student with too much new material in any single chapter. Problem material is designed to provide variety and to maintain student interest.

The first twelve chapters of the book cover business combinations, the equity method of accounting as a one-line consolidation, and consolidated financial statements. Accounting under generally accepted accounting principles is emphasized in the first eleven chapters, but the constraints of generally accepted accounting principles are removed in Chapter 12, which compares the parent company, entity, and contemporary theories of consolidation.

Chapter 12 also considers possible effects of replacement cost accounting on the preparation of consolidated financial statements.

Chapter 2 of the book introduces the equity method of investor accounting as a one-line consolidation. The one-line consolidation is an essential area in the study of consolidations because consolidated financial statements frequently include one or more non-consolidated subsidiaries and other equity method investments. But more important, the one-line consolidation concept is an important pedagogical tool in teaching the concepts and procedures of consolidations because it permits alternate computational approaches for such key items as consolidated net income and consolidated retained earnings. This helps the instructor explain the objectives of consolidation procedures and its permits students to check their logic by doing something different.

The equity method of accounting as a one-line consolidation is integrated throughout Chapters 3 through 11, but the book does not ignore situations in which a parent company uses the cost method or a simple equity method to account for subsidiary investments. To the contrary, the cost and simple equity methods are also illustrated in the text and included in the assignment material so that the student will be flexible enough to handle consolidations regardless of the method used by the parent company in accounting for its subsidiary investments.

Both the trial balance and the financial statement approaches for consolidation working papers are illustrated and used in the text. This working paper coverage is designed to prepare students for various situations that they may encounter. It also teaches students to use the most logical and efficient working paper format for the data presented. If data are presented in trial balance format, the trial balance approach will lead to the most efficient solution. Alternatively, if the data are presented in the financial statement format, the financial statement approach will be most convenient. Identical working paper adjustment and elimination entries are used for the alternate working paper formats to enable students to switch from one working paper format to the other without difficulty.

Chapters 5, 6, and 7 cover intercompany profit transactions involving inventories, plant assets, and bonds, respectively. These topics are presented in separate chapters primarily because they are areas in which students frequently have some difficulty. I believe that students learn the material faster and better by studying the areas one at a time. This same type of separation has been applied in Chapters 10 and 11 which cover indirect holdings and mutual holdings. The separation of the above topics by chapter should be helpful to instructors who choose to omit one or more topics from their advanced accounting courses. Except for integration in some assignment material, Chapter 7 can be omitted without affecting sub-



sequent coverage. Chapters 10 and 11 can be omitted, if necessary, but Chapter 11 is dependent upon assignment of Chapter 10.

Chapters 13, 14, and 15 cover branch accounting, foreign currency transactions and financial statements, and financial reporting for industry segments. These chapters should be assigned sometime after Chapter 9, and in sequence, because Chapter 14 covers foreign branches and subsidiaries, and Chapter 15 includes disclosures for foreign segments and reconciliations of segment information with amounts shown in consolidated financial statements. If necessary, however, Chapter 13 on branch accounting can be assigned before the consolidation chapters, or it can be omitted if the last section of Chapter 14 that covers foreign branches is also omitted.

The last four chapters in the book include two chapters on accounting for partnerships (Chapters 16 and 17) and two chapters on accounting for state and local governmental units (Chapters 18 and 19). These chapters are not dependent on any other chapters in the book and may be undertaken anytime, provided that Chapter 16 is covered before Chapter 17 and that Chapter 18 is covered before Chapter 19.

## ACKNOWLEDGMENTS

The completion of a textbook requires the help and cooperation of many people and it is not possible to acknowledge individually all of those who have made significant contributions. I have received many good suggestions and deserving criticisms from my students at Virginia Polytechnic Institute and State University, and I gratefully acknowledge their collective contributions.

My sincere thanks for a job well done go to Professors Richard E. Baker, Indiana University; Frank Bird, University of Richmond; James Deitrick, The University of Texas at Austin; Manson Peter Dillaway, Virginia Polytechnic Institute and State University; and Richard Murdock, Ohio State University who reviewed all or portions of the manuscript. A number of ideas and suggestions from these reviewers have been incorporated into the book. Of course, any remaining shortcomings continue to be my own responsibility.

I also want to express my appreciation to the American Institute of Certified Public Accountants, the Financial Accounting Standards Board, and the Municipal Finance Officers Association for granting permission to quote from their pronouncements. I am also indebted to the American Institute of Certified Public Accountants for permission to use problem materials adapted from their Uniform CPA Examinations.

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## *Business Combinations*

A *business combination* involves expansion through the union of business entities. The uniting of separate business entities is an alternative to 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, diversification of business risks through conglomerate operations, income and estate tax advantages, and the reduction of competition. Federal laws do, of course, prohibit combinations that would be in restraint of trade or that would impair competition.<sup>1</sup>

### **THE ACCOUNTING CONCEPT OF A BUSINESS COMBINATION**

The accounting concept of a business combination is reflected in *Accounting Principles Board (APB) Opinion No. 16* that 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.<sup>2</sup>

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<sup>1</sup> See the Sherman Act of 1890 and Clayton Act of 1914.

<sup>2</sup> *APB Opinion No. 16*, "Business Combinations," paragraph 1.

Note that the accounting concept of a business combination emphasizes the accounting 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.

Businesses are brought together into one accounting entity when all their business resources and operations come under the control of a single management team. Such control within one accounting entity is established in business combinations in which:

1. one or more corporations become subsidiaries,
2. one company transfers its net assets to another, or
3. each company transfers its net assets to a newly formed corporation.<sup>3</sup>

1. A corporation becomes a *subsidiary* when another corporation acquires a majority (over 50 percent) of its outstanding voting stock. (The term “subsidiary” is explained in detail on pages 42, 82, and 83.) Thus, a business combination can be consummated through acquisition of less than 100 percent of the stock of another corporation. In business combinations in which less than 100 percent of the voting stock of other combining companies is acquired, the combining companies necessarily retain their separate legal identities and separate accounting records even though they have become one accounting entity.

2. Business combinations in which one company transfers its net assets to another can be consummated in a variety of ways, but the acquiring company must acquire 100 percent of the net assets in any case. For example, Company A may purchase the net assets of Company B directly from Company B for cash, for other assets, or for Company A stock. Alternatively, Company A may purchase Company B stock directly from Company B’s stockholders for cash, for other assets, or for Company A stock. If Company B is dissolved pursuant to the laws of its state of incorporation, the business combination is designated as a *merger* or a *statutory merger*. But dissolution of Company B is not required within the accounting concept of a business combination and the decision to dissolve or not to dissolve Company B does not affect Company A’s accounting for the net assets acquired.

3. Alternatively, each combining company can transfer its net assets to a newly formed corporation. Since the newly formed corporation has no net assets of its own, it issues its stock to the other combining companies or to their stockholders or owners. For example, Company A, a newly formed corporation, may acquire the net

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<sup>3</sup>APB Opinion No. 16, paragraph 5.



assets of Company B and Company C by issuing its stock to Company B and Company C or to the stockholders of Company B and Company C. If Companies B and C are dissolved under the laws of their states of incorporation, the business combination is designated as a *consolidation* or a *statutory consolidation*. Dissolution of the combining companies is not required to have a business combination in the accounting sense, however, and Company A's accounting for the net assets acquired is not affected by the decisions to dissolve or not to dissolve Company B and Company C.

The terms "merger" and "consolidation" are used above in their technical or legal sense. In their broader and general usage, the terms are used interchangeably with the expression business combination. References to "the merger movement prior to 1900" and to "the wave of business consolidations in the 1960s" are examples of the general usage of the terms. 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, 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. The term "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.

### **Brief Background on Accounting for Business Combinations**

Accounting for business combinations is one of the most important and interesting topics of accounting theory and practice. At the same time, accounting for business combinations is one of the most complex and controversial areas of accounting thought. Business combinations are important and interesting because they involve financial transactions of enormous magnitudes, business empires, success stories and personal fortunes, executive genius, and management fiascos. By their nature they necessarily involve the take-over of entire companies. Business combinations are complex because each one is unique and must be evaluated in terms of its economic substance, irrespective of its legal form. An excellent summary of the nature and extent of current merger activity was published in the *Roanoke Times & World News*. Because of its relevance to the study of business combinations, the article is reproduced in Exhibit 1-1.

Much of the controversy concerning accounting requirements for business combinations involves the pooling of interests method which became generally accepted in 1950 when the Committee on Accounting Procedure issued *Accounting Research Bulletin (ARB)*

*No. 40.* Although there are conceptual difficulties with the pooling method, the underlying problem that arose with *ARB No. 40* was the introduction of alternative methods of accounting for business combinations (pooling versus purchase). Numerous financial interests are involved in a business combination, and alternate accounting procedures may not be neutral with respect to different interests. That is, the individual financial interests and the final plan of combination may be affected by the method of accounting.

#### EXHIBIT 1-1. Business Mergers Rising Again, but Deals More Cautious

New York (AP)— There was a time when words like “romance” were used to describe negotiations for corporate acquisitions and “marriage” was a colorful term for merger.

But the sweetheart analogy scarcely applies to the latest wave of corporate combinations. Some have been fought bitterly by the company pursued. Others are carried out with the cold-hearted cunning of a predator.

Carborundum Co., a Niagara Falls, N.Y., producer of abrasive products, surprised Wall Streeters this past week, in a widely followed acquisition struggle, when it commanded a \$66-per-share takeover price from Kennecott Copper Corp.

The price was nearly twice as high as Carborundum stock had been trading for much of the year on the New York Stock Exchange and the purchase offer, which has a total value of more than \$521 million, reportedly upset some stockholders of Kennecott.

One reason was that Kennecott was rumored to be ripe for acquisition itself because of profit problems brought on by a general slump in the copper industry.

Instead, the company took the offensive. It outbid Eaton Corp., a Cleveland-based maker of vehicle parts, which had offered \$47 a share for Carborundum several weeks earlier and reportedly felt the need to top a \$60 per share “expression of interest” from some prospective bidder.

The past week’s actions are a good example of what has been going on lately. Analysts say merger deals are nearing the record dollar volumes of the late 1960s. However, the number of individual deals and general trend may show a more cautious approach than the furious pace of the late 1960s.

In addition to Carborundum, other big mergers this year have included PepsiCo’s \$313 million acquisition of Pizza Hut; Continental Group’s \$293 million takeover of Richmond Corp., and Gulf Oil’s \$440 million acquisition of Kewanee Industries.

According to W. T. Grimm & Co., a Chicago-based merger specialist, the total dollar volume of mergers announced last year came to \$20.02 billion and may well exceed that this year.

That still is below the 1969 record of \$24 billion and nowhere near the furious pace of individual deals which saw more than 6,000 merger announcements in 1969, against about 2,300 last year.

One widely cited reason for the rebirth in mergers is simply that inflation has pushed up the cost of construction and equipment so much in recent years that corporations find it cheaper to buy up existing profitable companies than expand or begin new operations of their own.

Associated Press Article in *Roanoke Times & World News*, November 20, 1977, p. D-2.

Current accounting requirements for business combinations are reflected in *APB Opinion No. 16* which continues to recognize both the pooling and the purchase methods of accounting for business

combinations, but not as alternative methods of accounting for the same business combination. Even so, two very different methods of accounting for business combinations are recognized and generally accepted and the controversy continues. Evidence of continued opposition to current accounting requirements is reflected by the fact that “a reconsideration of *APB Opinion No. 16*” was placed on the agenda of the Financial Accounting Standards Board (FASB) in 1973, the year in which the FASB replaced the APB.<sup>4</sup> A task force of the FASB has studied the problem of business combinations since 1974.

### Methods of Accounting for Business Combinations

Currently, there are two generally accepted methods of accounting for business combinations—the pooling of interests method and the purchase method. But the two methods “are not alternatives in accounting for the same business combination.”<sup>5</sup> A business combination that meets the criteria of *APB Opinion No. 16* for a pooling of interests must be accounted for under the pooling method. All other business combinations must be accounted for under the purchase method.

**Pooling of Interest Method.** The two methods are based on different assumptions about the nature of a business combination. Under the pooling of interests method, it is assumed that the ownership interests of the combining companies are united and continue relatively unchanged in the new accounting entity. Since none of the combining companies are considered to have acquired the other combining companies, there is no purchase, no purchase price, and, accordingly, no new basis of accountability. Under the pooling method, the assets and liabilities of the combining companies are carried forward to the combined entity at book value. Retained earnings of the combining companies is also carried forward to the “pooled” entity, and income of the pooled entity includes the incomes of the combining companies for the entire year regardless of the date on which the business combination is consummated.

**Purchase Method.** The purchase method is based on the assumption that a business combination is a transaction in which one entity acquires the net assets of the other combining companies. Under the purchase method the acquiring corporation records the net assets received at their fair value at the time of the business combination. The cost of the acquired company is determined in the same manner as for other transactions. This cost is allocated to identifiable assets and liabilities acquired according to their fair values at the date of combination. Any excess of cost over the fair value of

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<sup>4</sup> FASB, *Status Report*, No. 6, November 28, 1973, p. 1.

<sup>5</sup> *APB Opinion No. 16*, paragraph 43.