Essentials of Advanced Financial Accounting

Richard E. Baker
Northern Illinois University

Theodore E. Christensen
Brigham Young University

David M. Cottrell
Brigham Young University

With contributions from:

Valdean C. Lembke
Professor Emeritus
University of Iowa

Thomas E. King
Professor Emeritus
Southern Illinois University, Edwardsville

Cynthia G. Jeffrey
Iowa State University
# Table of Contents

**ABOUT THE AUTHORS** v

**PREFACE** vii

**Chapter 1**

Intercorporate Acquisitions and Investments in Other Entities 1

Kraft’s Acquisition of Cadbury 1

A Brief Introduction 2

The Development of Complex Business Structures 4

Enterprise Expansion 5

Organizational Structure and Business Objectives 5

Organizational Structure, Acquisitions, and Ethical Considerations 6

Business Expansion and Forms of Organizational Structure 6

Internal Expansion 6

External Expansion through Business Combinations 7

Frequency of Business Combinations 8

Complex Organizational Structures 9

Organizational Structure and Financial Reporting 10

Creating Business Entities 10

Business Combinations 12

Forms of Business Combinations 12

Methods of Effecting Business Combinations 12

Valuation of Business Entities 14

Accounting for Business Combinations 15

Acquisition Accounting 16

Fair Value Measurements 16

Applying the Acquisition Method 16

Goodwill 17

Combination Effected through the Acquisition of Net Assets 18

Combination Effected through Acquisition of Stock 22

Financial Reporting Subsequent to a Business Combination 23

Disclosure Requirements 24

Additional Considerations in Accounting for Business Combinations 24

Uncertainty in Business Combinations 24

In-Process Research and Development 26

Noncontrolling Equity Held Prior to Combination 26

Acquisitions by Contract Alone 26

Summary of Key Concepts 26

Key Terms 27

**APPENDIX 1A**

Methods of Accounting for Business Combinations 27

Questions 28

Cases 29

Exercises 32

Problems 43

**Chapter 2**

Reporting Intercorporate Investments and Consolidation of Wholly Owned Subsidiaries with No Differential 53

Berkshire Hathaway’s Many Investments 53

Accounting for Investments in Common Stock 54

Reasons for Investing in Common Stock 56

The Cost Method 57

Accounting Procedures under the Cost Method 57

Declaration of Dividends in Excess of Earnings since Acquisition 57

Acquisition at Interim Date 59

Changes in the Number of Shares Held 59

The Equity Method 59

Use of the Equity Method 60

Investor’s Equity in the Investee 60

Recognition of Income 60

Recognition of Dividends 61

Comparison of the Carrying Amount of the Investment under the Cost and Equity Methods 62

Acquisition at Interim Date 62

Changes in the Number of Shares Held 63

Comparison of the Cost and Equity Methods 65

The Fair Value Option 66

Overview of the Consolidation Process 66

Consolidation Procedures for Wholly Owned Subsidiaries That Are Created or Purchased at Book Value 67

Consolidation Worksheets 67

Worksheet Format 67

Nature of Eliminating Entries 69

Consolidated Balance Sheet with Wholly Owned Subsidiary 69

100 Percent Ownership Acquired at Book Value 70

Consolidation Subsequent to Acquisition 73

Consolidated Net Income 74

Consolidated Retained Earnings 75

Consolidated Financial Statements—100 Percent Ownership, Created or Acquired at Book Value 76

Initial Year of Ownership 77

Second and Subsequent Year of Ownership 81

Consolidated Net Income and Retained Earnings 83

Summary of Key Concepts 84
Chapter 3
The Reporting Entity and Consolidation of Less-than-Wholly-Owned Subsidiaries with No Differential 107

The Collapse of Enron and the Birth of a New Paradigm 107
The Usefulness of Consolidated Financial Statements 109
Limitations of Consolidated Financial Statements 109
Subsidiary Financial Statements 110
Consolidated Financial Statements: Concepts and Standards 110

- Traditional View of Control 110
- Indirect Control 111
- Ability to Exercise Control 111
- Differences in Fiscal Periods 112
- Changing Concept of the Reporting Entity 112

Special-Purpose and Variable Interest Entities 113

- Off-Balance Sheet Financing 113
- Variable Interest Entities 114
- IFRS Differences in Determining Control of VIEs and SPEs 116

Noncontrolling Interest 116

- Computation of Noncontrolling Interest 116
- Presentation of Noncontrolling Interest 116

Combined Financial Statements 118

Additional Considerations—Different Approaches to Consolidation 119

- Theories of Consolidation 119
- Comparison of Alternative Theories 119
- Current Practice 122

The Effect of a Noncontrolling Interest 122

- Consolidated Net Income 122
- Consolidated Retained Earnings 123
- Worksheet Format 124

Consolidated Balance Sheet with a Less-than-Wholly-Owned Subsidiary 124

- 80 Percent Ownership Acquired at Book Value 125
- Consolidation Subsequent to Acquisition—80 Percent Ownership Acquired at Book Value 127
- Initial Year of Ownership 127
- Second and Subsequent Years of Ownership 131

Summary of Key Concepts 133

Chapter 4
Consolidation of Wholly Owned Subsidiaries Acquired at More than Book Value 157

How Much Work Does It Really Take to Consolidate?
Ask the People Who Do It at Disney 157
Dealing with the Differential 158

- The Difference between Acquisition Price and Underlying Book Value 159

Consolidation Procedures for Wholly Owned Subsidiaries Acquired at More than Book Value 162

- Treatment of a Positive Differential 165
- Illustration of Treatment of a Complex Differential 166
- 100 Percent Ownership Acquired at Less than Fair Value of Net Assets 169
- Illustration of Treatment of Bargain-Purchase Differential 169

Consolidated Financial Statements—100 Percent Ownership Acquired at More than Book Value 171

- Initial Year of Ownership 171
- Second Year of Ownership 176

Intercompany Receivables and Payables 180

Push-Down Accounting 180
Summary of Key Concepts 181
Key Terms 181

Chapter 5
Consolidation of Less-than-Wholly-Owned Subsidiaries Acquired at More than Book Value 206

Cisco Acquires a Controlling Interest in Nuova 206
A Noncontrolling Interest in Conjunction with a Differential 207

Consolidated Balance Sheet with Majority-Owned Subsidiary 207
Consolidated Financial Statements with a Majority-Owned Subsidiary 210

- Initial Year of Ownership 210
- Second Year of Ownership 214

Discontinuance of Consolidation 217
Chapter 6
Intercompany Inventory Transactions 254

Inventory Transfers at Toys R Us 254
Overview of the Consolidated Entity and Intercompany Transactions 255
   Elimination of Intercompany Transfers, 256
   Elimination of Unrealized Profits and Losses 256
Inventory Transactions 256
   Transfers at Cost 257
   Transfers at a Profit or Loss 257
   Effect of Type of Inventory System 257
Downstream Sale of Inventory 258
   Resale in Period of Intercorporate Transfer 259
   Resale in Period following Intercorporate Transfer 260
   Inventory Held for Two or More Periods 266
Upstream Sale of Inventory 267
   Equity-Method Entries—20X1 267
   Consolidation Worksheet—20X1 268
   Consolidated Net Income—20X1 269
   Equity-Method Entries—20X2 270
   Consolidation Worksheet—20X2 270
   Consolidated Net Income—20X2 272
Additional Considerations 272
   Sale from One Subsidiary to Another 272
   Costs Associated with Transfers 273
   Lower of Cost or Market 273
   Sales and Purchases before Affiliation 273
Summary of Key Concepts 274
Key Terms 274
APPENDIX 6A
Intercompany Inventory Transactions—Modified Equity Method and Cost Method 274

Chapter 7
Intercompany Transfers of Services and Noncurrent Assets 306

Micron’s Intercompany Fixed Asset Sale 306
Intercompany Long-Term Asset Transfers 307
Intercompany Transfers of Services 309
Intercompany Land Transfers 309
   Overview of the Profit Elimination Process 309
   Assignment of Unrealized Profit Elimination 311
   Downstream Sale of Land 313
   Upstream Sale of Land 317
   Eliminating the Unrealized Gain after the First Year 321
   Subsequent Disposition of the Asset 321
Intercompany Transfers of Depreciable Assets 323
   Downstream Sale 323
   Change in Estimated Life of Asset upon Transfer 331
   Upstream Sale 331
   Asset Transfers before Year-End 341
Intercompany Transfers of Amortizable Assets 341
Summary of Key Concepts 341
Key Terms 341
APPENDIX 7A
Intercompany Noncurrent Asset Transactions—Modified Equity Method and Cost Method 342
Questions 349
Cases 350
Exercises 352
Problems 360

Chapter 8
Multinational Accounting: Foreign Currency Transactions and Financial Instruments 373

Microsoft’s Multinational Business 373
Doing Business in a Global Market 374
The Accounting Issues 375
Foreign Currency Exchange Rates 376
   The Determination of Exchange Rates 376
   Direct versus Indirect Exchange Rates 376
   Changes in Exchange Rates 378
   Spot Rates versus Current Rates 381
   Forward Exchange Rates 381
Foreign Currency Transactions 381
   Foreign Currency Import and Export Transactions 383
<table>
<thead>
<tr>
<th>Chapter 9</th>
<th>Page</th>
</tr>
</thead>
<tbody>
<tr>
<td>Multinational Accounting: Issues in</td>
<td></td>
</tr>
<tr>
<td>Financial Reporting and Translation of</td>
<td></td>
</tr>
<tr>
<td>Foreign Entity Statements</td>
<td></td>
</tr>
<tr>
<td>McDonald’s—The World’s Fast Food</td>
<td></td>
</tr>
<tr>
<td>Favorite</td>
<td></td>
</tr>
<tr>
<td>Differences in Accounting Principles</td>
<td></td>
</tr>
<tr>
<td>Determining the Functional Currency</td>
<td></td>
</tr>
<tr>
<td>**Functional Currency Designation in Highly</td>
<td></td>
</tr>
<tr>
<td>Inflationary Economies</td>
<td></td>
</tr>
<tr>
<td>Translation versus Remeasurement of Foreign</td>
<td></td>
</tr>
<tr>
<td>Financial Statements</td>
<td></td>
</tr>
<tr>
<td>Translation of Functional Currency Statements into</td>
<td></td>
</tr>
<tr>
<td>the Reporting Currency of the U.S. Company</td>
<td></td>
</tr>
</tbody>
</table>

| Chapter 10                                         |      |
| Partnerships: Formation, Operation, and Changes in |      |
| Membership                                         |      |
| The Evolution of PricewaterhouseCoopers (PwC)      |      |
| The Nature of the Partnership Entity               |      |
| **Legal Regulation of Partnerships**               |      |
| **Definition of a Partnership**                    |      |
| **Formation of a Partnership**                     |      |
| **Other Major Characteristics of Partnerships**    |      |
| Accounting and Financial Reporting Requirements    |      |
| for Partnerships                                    |      |
| **International Financial Reporting Standards for**|      |
| **Small and Medium-Sized Entities and Joint Ventures** |      |
Accounting for the Formation of a Partnership 512
   Illustration of Accounting for Partnership Formation 513
Accounting for the Operations of a Partnership 514
   Partners' Accounts 514
Allocating Profit or Loss to Partners 515
   Illustrations of Profit Allocation 516
   Multiple Bases of Profit Allocation 519
   Special Profit Allocation Methods 520
Partnership Financial Statements 520
Changes in Membership 521
   General Concepts to Account for a Change in Membership in the Partnership 521
   New Partner Purchases an Interest 523
   New Partner Invests in Partnership 525
   Determining a New Partner's Investment Cost 538
   Dissociation of a Partner from the Partnership 538
Summary of Key Concepts 541
Key Terms 541
APPENDIX 10A
Tax Aspects of a Partnership 541
APPENDIX 10B
Joint Ventures 543
Questions 545
Cases 545
Exercises 548
Problems 554

Chapter 11
Partnerships: Liquidation 561
The Demise of Laventhol & Horwath 561
Overview of Partnership Liquidations 562
   Dissociation, Dissolution, Winding Up, and Liquidation of a Partnership 562
Lump-Sum Liquidations 564
   Realisation of Assets 564
   Expenses of Liquidation 564
   Illustration of Lump-Sum Liquidation 564
Installment Liquidations 569
   Illustration of Installment Liquidation 570
   Cash Distribution Plan 573
Additional Considerations 576
   Incorporation of a Partnership 576
Summary of Key Concepts 577
Key Terms 578
APPENDIX 11A
Partners' Personal Financial Statements 578
Questions 581
Cases 582
Exercises 584
Problems 593

Chapter 12
Governmental Entities: Introduction and General Fund Accounting 599
Accounting for the Bustling City of San Diego 599
 Differences between Governmental and Private Sector Accounting 600
History of Governmental Accounting 601
Major Concepts of Governmental Accounting 602
   Elements of Financial Statements 602
   Expendability of Resources versus Capital Maintenance Objectives 603
   Definitions and Types of Funds 603
Financial Reporting of Governmental Entities 605
   Fund-Based Financial Statements: Governmental Funds 606
Measurement Focus and Basis of Accounting (MFBA) 609
   Basis of Accounting—Governmental Funds 610
   Basis of Accounting—Proprietary Funds 613
   Basis of Accounting—Fiduciary Funds 613
Budgetary Aspects of Governmental Operations 614
   Recording the Operating Budget 614
Accounting for Expenditures 615
   The Expenditure Process 615
   Classification of Expenditure Transactions and Accounts 617
   Outstanding Encumbrances at the End of the Fiscal Period 617
Expenditures for Inventory 621
Accounting for Fixed Assets 623
   Long-Term Debt and Capital Leases 624
   Investments 624
Interfund Activities 625
   (1) Interfund Loans 625
   (2) Interfund Services Provided and Used 626
   (3) Interfund Transfers 626
   (4) Interfund Reimbursements 627
Overview of Accounting and Financial Reporting for the General Fund 627
Comprehensive Illustration of Accounting for the General Fund 628
   Adoption of the Budget 628
   Property Tax Levy and Collection 630
   Other Revenue 631
   Expenditures 632
   Acquisition of Capital Asset 632
   Interfund Activities 633
   Adjusting Entries 633
   Closing Entries 634
   General Fund Financial Statement Information 635
Summary of Key Concepts 638
Chapter 13
Governmental Entities: Special Funds and Government-wide Financial Statements 658

Governmental Accounting in Maryland 658
Summary of Governmental Fund Types 660
Governmental Funds Worksheets 661
Special Revenue Funds 661
Capital Projects Funds 665
Illustration of Transactions 665
Financial Statement Information for the Capital Projects Fund 668
Debt Service Funds 668
Illustration of Transactions 669
Financial Statement Information for the Debt Service Fund 671
Permanent Funds 671
Illustration of Transactions 671
Governmental Funds Financial Statements 672
Enterprise Funds 675
Illustration of Transactions 676
Financial Statements for the Proprietary Funds 678
Internal Service Funds 680
Illustration of Transactions 681
Financial Statements for Internal Service Funds 683
Trust Funds 683
Illustration of Private-Purpose Trust Fund 684
Agency Funds 685
Illustration of Transactions in an Agency Fund 686
The Government Reporting Model 686
Four Major Issues 686
Government Financial Reports 688
Government-wide Financial Statements 689
Reconciliation Schedules 691
Budgetary Comparison Schedule 693
Management's Discussion and Analysis 695
Notes to the Government-wide Financial Statements 695
Other Financial Report Items 696
Interim Reporting 696
Auditing Governmental Entities 696
Additional Considerations 697
Special-Purpose Governmental Entities 697
Financial Reporting for Pensions and OPEB Plans 698
Summary of Key Concepts 699
Key Terms 700
APPENDIX 13A
Other Governmental Entities—Public School Systems and the Federal Government 700
Questions 702
Cases 702
Exercises 704
Problems 715
INDEX 727