**CHAPTER 1**

**INTERCORPORATE ACQUISITIONS AND INVESTMENTS**

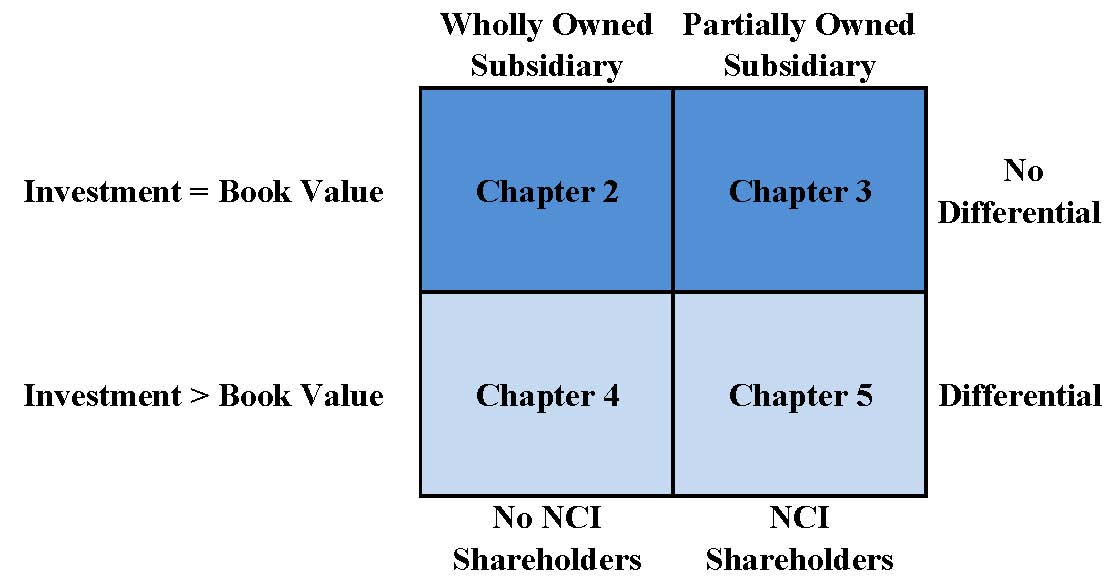
**IN OTHER ENTITIES**

**IMPORTANT NOTE TO INSTRUCTORS**

The 11th edition of Advanced Financial Accounting continues the approach to consolidation which was used in the 10th edition. While we encourage instructors to read through the description of all changes in the 11th edition provided in the preface to the book, we summarize this consolidation approach here since it is the fundamental organizational structure for several chapters in the text. As this approach is developed in chapters 2-5 we believe it offers students an intuitive foundation for developing consolidated financial statements. We summarize the two main features in our approach to consolidation in the 11th edition here:

* A Building-Block Approach to Consolidation—Virtually all advanced financial accounting classes cover consolidation topics. While this topic is perhaps the most important to instructors, students frequently struggle to gain a firm grasp of consolidation principles. This edition provides students with a learning friendly framework to consolidations by introducing consolidation concepts and procedures gradually. This is accomplished by a building-block approach which introduces consolidations earlier than some texts by beginning the consolidation discussion in chapters 2 and 3. The building-block approach can be summarized as follows:
* ***Chapter 2*** begins with the most basic consolidation situation: the consolidation of a wholly owned subsidiary that is either created or purchased at an amount equal to the book value of net assets. Thus, students practice basic consolidation procedures without having to worry about the complications associated with a differential or with noncontrolling shareholders.
* ***Chapter 3*** introduces the notion of partial ownership of a subsidiary that is created or acquired at an amount equal to the book value of net assets. In this way students are exposed to the nuances associated with the existence of noncontrolling shareholders, but without the details associated with a differential.
* ***Chapter 4*** exposes students to the intricacies of consolidation when the subsidiary is acquired for an amount that exceeds the book value of net assets. In order to isolate the new concepts and procedures that accompany the consolidation of a subsidiary with a differential, this chapter focuses on wholly owned subsidiaries.
* ***Chapter 5***finally brings students full circle to the point where they are ready to tackle more realistic situations where the parent company purchases a controlling interest in a subsidiary (but less than 100% ownership) and the acquisition price exceeds the book value of net assets. Thus, students learn how to simultaneously handle all of the details associated with a differential and with noncontrolling shareholders.

The overall coverage of the consolidation process by chapter is illustrated below.



* Organization of Consolidation Entries—Consistent with the building block approach to consolidation, the this edition facilitates the elimination of the investment in a subsidiary in two steps: (1) first the book value portion of the investment and income from the subsidiary are eliminated and (2) then the differential portion of the investment and income from subsidiary are eliminated with separate entries. This approach facilitates the building-block approach in chapters 2-5. This edition also uses frequent illustrations to help students visualize the steps in the consolidation process.

**OVERVIEW OF CHAPTER 1**

Chapter 1 provides students with an understanding of the legal forms of business combinations and the financial statement effects of the accounting procedures used in recording a business combination. It also discusses the proliferation of complex organizational structures and regulatory as well as ethical considerations. This chapter fully illustrates accounting for business combinations on the date of acquisition, using the acquisition method, both for business combinations effected through an acquisition of net assets and by an acquisition of common shares.

The discussions contain specific illustrations of the valuation of tangible and intangible assets and liabilities held by the acquired company on the date of acquisition. Chapter 1 also illustrates the measurement and reporting of goodwill and the treatment of a bargain purchase and discusses the impairment of goodwill. It also explains the treatment of costs associated with completing a merger and the associated disclosure requirements.

The Additional Considerations portion of the chapter discusses factors adding to uncertainty in business combinations; in-process research and development; and noncontrolling equity held prior to combination.

**LEARNING OBJECTIVES**

When students finish studying this chapter, they should be able to:

LO 1-1 Understand and explain the reasons for and different methods of business expansion, the types of organizational structures, and the types of acquisitions.

LO 1-2 Understand the development of standards related to acquisition accounting over time.

LO 1-3 Make calculations and prepare journal entries for the creation of a business entity.

LO 1-4 Understand and explain the differences between different forms of business combinations.

LO 1-5 Make calculations and business combination journal entries in the presence of a differential, goodwill, or a bargain purchase element.

LO 1-6 Understand additional considerations associated with business combinations.

**SYNOPSIS OF CHAPTER 1**

**Intercorporate Acquisitions and Investments in Other Entities**

Kraft’s Acquisition of Cadbury

A Brief Introduction

LO 1-1 Understand and explain the reasons for and different methods of business expansion, the types of organizational structures, and the types of acquisitions.

An Introduction to Complex Business Structures

Enterprise Expansion

Business Objectives

Frequency of Business Combinations

Ethical Considerations

Business Expansion and Forms of Organizational Structure

Internal Expansion: Creating a Business Entity

External Expansion: Business Combinations

Organizational Structure and Financial Reporting

LO 1-2 Understand the development of standards related to acquisition accounting over time.

The Development of Accounting for Business Combinations

LO 1-3 Make calculations and prepare journal entries for the creation of a business entity.

Accounting for Internal Expansion: Creating Business Entities

LO 1-4 Understand and explain the differences between different forms of business combinations.

Accounting for External Expansion: Business Combinations

Legal Forms of Business Combinations

Methods of Effecting Business Combinations

Valuation of Business Entities

LO 1-5 Make calculations and business combination journal entries in the presence of a differential, goodwill, or a bargain purchase element.

Acquisition Accounting

Fair Value Measurements

Applying the Acquisition Method

Goodwill

Combination Effected through the Acquisition of Net Assets

Combination Effected through Acquisition of Stock

Financial Reporting Subsequent to a Business Combination

LO 1-6 Understand additional considerations associated with business combinations.

Additional Considerations in Accounting for Business Combinations

Uncertainty in Business Combinations

In-Process Research and Development

Noncontrolling Equity Held Prior to Combination

**NOTES ON POWERPOINT SLIDES**

We have attempted to provide PowerPoint slides that will be useful to a broad set of users.  Since instructors often have different styles and preferences, we have attempted to include slides that will accommodate different approaches and that can be adapted to classes with different levels of preparation.  For example, some instructors prefer to introduce the material before students have read the chapter.  We have tried to facilitate these types of introductory discussions by including slides that replicate key points from the chapter. Other instructors expect students to have read the chapter and attempted homework problems before coming to class.  As a result, they may not find it useful to review all of the topics in the chapter or to include slides that simply review many of the details they expect students to study before class.  However, instructors following this approach often like to use sample exercises and problems built into the slides that allow them to have extended discussions or to facilitate group interaction in class.

If instructors elect to spend two class periods on the same subject, they might find a combination of both styles to be useful by first introducing foundational material before students have read the chapter and studied the topic, followed by an extended discussion the next class period after students have read the chapter and attempted homework problems.

We have tried to develop slides that can facilitate a flexible approach to allow instructors to select the slides that best match their objectives and style for class discussions.  This is the reason we are including over 100 slides for some chapters in the text.  We do not expect all instructors to use all slides, but the slide files should help support different teaching approaches and allow instructors to select the subset of slides that best matches their specific discussion objectives.

The slides are organized by learning objective. We have included a slide at the beginning of each learning objective to show where the new material begins. Instructors may or may not want to use these learning objective slides in class. We provide them primarily as a way of organizing the material. We also include short multiple choice questions at the end of most learning objectives. Some instructors find it useful to pause periodically during class to assess students’ level of understanding. For this reason, we include several “practice quiz questions” that can be used throughout class discussions to engage students, help them focus on key points, or to facilitate group interaction. Finally, we provide longer exercises and problems that many instructors find useful in assessing understanding and encouraging group learning.

LO 1-1 Understand and explain the reasons for and different methods of business expansion, the types of organizational structures, and the types of acquisitions.

* Slides 3-14 summarize basic concepts related to LO1.
* Slide 7 provides a visual overview of internal and external expansion
* Instructors should choose slides from this LO that they deem most important to emphasize to their students

LO 1-2 Understand the development of standards related to acquisition accounting over time.

* Slides 18-20 summarize basic concepts related to LO 1-2.
* Instructors should choose slides from this LO that they deem most important to emphasize to their students

LO 1-3 Make calculations and prepare journal entries for the creation of a business entity.

* Slide 26 summarize basic concepts related to LO3.
* Slide 27 provides a hands-on example about internal expansion to allow students to think through the journal entries on the parent’s and subsidiary’s books. This example is set up to engage students without spending a lot of time. Display the example information and ask students to explain what journal entries the parent (Slide 28) and subsidiary (Slide 29) would make. Instructors can click to show each journal entry as students give their answers.

LO 1-4 Understand and explain the differences between different forms of business combinations.

* Slides 33-44 summarize basic business combinations as presented in the chapter.
* Slides 45-56 provide additional diagrams and detail to help students better understand how these and other types of business combinations are consummated.

LO 1-5 Make calculations and business combination journal entries in the presence of a differential, goodwill, or a bargain purchase element.

* Slides 60-69 introduce the concepts of this learning objective with a simple example.
* Slides 70-78 summarize the accounting for acquisition-related costs classified into three general categories. The examples in slides 73-74 and 76-77 are helpful in giving students hands on practice. Some instructors find it useful to have students take a few minutes on each example to work individually or in small groups to attempt to solve each exercise.
* Slides 79-87 summarizes acquisition accounting for a combination resulting in goodwill using an asset acquisition to help students visualize the calculation and recording of goodwill.
* Slides 88-89 summarize accounting for an asset acquisition that results in a bargain purchase.
* Slides 90-97 use a practice exercise to help students visualize how accounting for a bargain purchase differs from a goodwill scenario.
* Slides 98-102 provide an overview of how intangibles acquired in an acquisition should be recorded. This topic is not covered extensively in the book. Instructors may find it useful to take a few minutes to mention this topic using these slides. In particular, slides 101-102 provide a brief example to help students understand how separately identifiable intangibles should be recorded separately from goodwill.
* Slide 103 is an optional example to illustrate the journal entries associated with acquisition accounting from the perspectives of both the acquiring and the target companies.
* Slides 104-106 summarize the journal entries that would be used in an acquisition of stock.
* Slide107 summarizes financial reporting subsequent to a business combination

LO 1-6 Understand additional considerations associated with business combinations.

* Slides 113-116 summarize basic concepts related to LO 1-6 (additional considerations).

Preview Slides:

Slides 117-122 introduce the notion of consolidation in a very basic manner. While chapter 1 alludes to consolidation briefly, it doesn’t go into any detail. Some instructors find it useful to introduce a very simplistic view of consolidation in chapter 1 as a teaser for chapters 2-5. While this material is not covered in the students’ reading, some instructors find it useful to use these slides to preview what students will be learning in the next several chapters.

**TEACHING IDEAS**

1. Students could be asked to prepare a "Company Mergers & Acquisitions History." Each student (or group) is assigned a company from the Fortune 500 list that appears annually in the April issue of Fortune. This could be reproduced and students could be assigned a company based on their seating order in the class. Alternatively, the instructor may have the list and then students may select a number between 1 and 100 at random and the instructor will tell them the name of "their" company. The students then must obtain the M&A activity of that company for the last 10 years from Moody's Industrial Manual or some similar source. Moody's presents this information at the beginning of each company's profile information. The students should determine the number and magnitude of the business combinations and investments for their company and prepare a historical time line showing the business combinations and any other information they can obtain on selected (or all) combinations. Several activities during the semester or quarter can be based on the student's company selection made at this time.

2. Students can be required to conduct a key word search online and asked to provide examples and brief descriptions of several different types of merger activities.

3. Students could access the Wall Street Journal on-line article data base and search for an article on a recent business combination. The students could be asked to provide a brief oral or written summary of the article.

**DESCRIPTIONS OF CASES, EXERCISES, AND PROBLEMS**

|  |  |
| --- | --- |
| **C1-1**  35 min.  LO 1-2, LO 1-5  M | **Assignment of Acquisition Costs**  Students must research the current authoritative accounting standards as well as any FASB proposals regarding the treatment of acquisition costs and report their findings. |
| **C1-2**  15 min.  LO 1-1, LO 1-3  M | **Evaluation of a Merger**  Students are asked to explain the funding of an acquisition as well as the impact on receivables and inventory. |
| **C1-3**  15 min.  LO 1-4  M | **Business Combinations**  Students must identify and evaluate tax incentives and other economic factors associated with the frequency of business combinations since the 1960s. |
| **C1-4**  25 min.  LO 1-5  E | **Determination of Goodwill Impairment**  Students must research the authoritative literature regarding impairment testing of goodwill. Students must report their findings and explain the type of tests used to determine whether goodwill has been impaired and provide some example that would indicate possible goodwill impairment. |
| **C1-5**  25 min.  LO 1-1  E | **Risks Associated with Acquisitions**  Students must discuss the risks that Google sees inherent in potential acquisitions after researching the information provided by the company to investors about its motivation for acquiring companies and the possible risks associated with such acquisitions. |
| **C1-6**  20 min.  LO 1-1  E | **Numbers Game**  Students must read Arthur Levitt’s speech “The Numbers Game” and explain the motivations and techniques for earnings management, as well as the significance of the issue. |
| **C1-7**  20 min.  LO 1-1, LO 1-4  M | **MCI: A Succession of Mergers**  Students are asked to look at the primary business activities and growth strategies of MCI WorldCom, Inc. They should trace the major acquisitions leading to MCI WorldCom and indicate the type of consideration used in the acquisitions. Some specific information is required. |

|  |  |
| --- | --- |
| **C1-8**  25 min.  LO 1-4  M | **Leveraged Buyouts**  Students must explain a leveraged buyout and contrast it with a management buyout. They must identify authoritative pronouncements and the major issue involved in determining proper basis for an interest in an LOB acquired company. |
| **E1-1**  20 min.  LO 1-1, LO 1-3, LO 1-5  M | **Multiple-Choice Questions on Complex Organizations**  A set of 5 multiple-choice questions testing students’ understanding of complex business organizations. |
| **E1-2**  20 min.  LO1-2, LO 1-5  E | **Multiple-Choice Questions on Recording Business Combinations**  [AICPA Adapted] A set of five multiple-choice questions test students’ basic understanding of recording business combinations. |
| **E1-3**  13 min.  LO 1-2, LO 1-5  M | **Multiple-Choice Questions on Reported Balances**  [AICPA Adapted] Four multiple-choice questions cover the computation of stockholders' equity and asset balances for the combined entity following a business combination. |
| **E1-4**  13 min.  LO 1-2, LO 1-5  M | **Multiple-Choice Questions Involving Account Balances**  Five multiple-choice questions cover the computation of account balances and related journal entries after a business combination. |
| **E1-5**  20 min.  LO 1-3  E | **Asset Transfer to Subsidiary**  Students are asked to show the journal entries made by the parent and subsidiary for the transfer of assets to the subsidiary. |
| **E1-6**  15 min.  LO 1-3  E | **Creation of New Subsidiary**  Students are asked to show the journal entries made by the parent and the subsidiary for the transfer of assets to the subsidiary. |

|  |  |
| --- | --- |
| **E1-7**  15 min.  LO 1-2, LO 1-3  E | **Balance Sheet Totals of Parent Company**  Journal entries are required for transfer of assets and accounts payable between a parent company and its newly created subsidiary. Both the parent and subsidiary journal entries must be made. |
| **E1-8**  12 min.  LO 1-2, LO 1-5  M | **Acquisition of Net Assets**  Students are required to show the journal entries that the parent must make at time of acquisition. |
| **E1-9**  20 min.  LO 1-5  M | **Reporting Goodwill**  Students must calculate goodwill to be reported under different acquisition prices. |
| **E1-10**  10 min.  LO 1-5  E | **Stock Acquisition**  Students must show the journal entry that the acquiring company must record when it issues stock for acquiring a subsidiary. |
| **E1-11**  20 min.  LO 1-5  M | **Balances Reported Following Combination**Students must calculate seven balances for balance sheet accounts immediately following a business combination. |
| **E1-12**  15 min.  LO 1-5  E | **Goodwill Recognition**  Students must show the journal entry to be made by the acquiring company in recording a business combination involving goodwill. |
| **E1-13**  15 min.  LO 1-5  M | **Acquisition Using Debentures**  Students must show the journal entry to be made by the acquiring company in recording a business combination executed using debentures. |
| **E1-14**  15 min.  LO 1-5  M | **Bargain Purchase**  Students must show the journal entry to be made by the acquiring company in recording a business combination involving gain on bargain purchase. |
| **E1-15**  20 min.  LO 1-5  M | **Impairment of Goodwill**  Students must calculate goodwill and potential impairment of goodwill given three different fair value amounts. |

|  |  |
| --- | --- |
| **E1-16**  15 min.  LO 1-5  M | **Assignment of Goodwill**  Students must calculate potential impairment of goodwill given three different fair value amounts. |
| **E1-17**  20 min.  LO 1-5  M | **Goodwill Assigned to Reporting Units**  Students must calculate reported goodwill for a company, based on information for four different reporting units. |
| **E1-18**  15 min.  LO 1-5  E | **Goodwill Measurement**  Students must calculate goodwill and potential impairment of goodwill given four different fair value amounts. |
| **E1-19**  20 min.  LO 1-5  M | **Computation of Fair Value**  Students must calculate the fair value of buildings and equipment, given the cost of acquisition, the fair value of other assets and liabilities, and the book value of the building and equipment. |
| **E1-20**  20 min.  LO 1-5  M | **Computation of Shares Issued and Goodwill**  Students must determine the number of shares issued, the par value of the acquiring company’s stock, and any goodwill arising from the business combination. |
| **E1-21**  15 min.  LO 1-5  M, Ws | **Combined Balance Sheet**  Students must prepare a balance sheet of the combined company immediately following the acquisition. |
| **E1-22**  20 min.  LO 1-5  M | **Recording a Business Combination**  Students must show the journal entries made by acquiring company given financial statement information for both companies and market value of the acquiring company’s common stock. |
| **E1-23**  15 min.  LO 1-5  M | **Reporting Income**  Students must compute net income and earnings-per-share reported in comparative income statement for two years. |
| **P1-24**  10 min.  LO 1-3  E | **Assets and Accounts Payable Transferred to Subsidiary**  Students must show journal entries recorded for transfer of assets and liabilities to the newly established subsidiary. |
| **P1-25**  10 min.  LO 1-3  E | **Creation of New Subsidiary**  Students must show journal entries made for the transfer of assets and liabilities to a newly created entity. |

|  |  |
| --- | --- |
| **P1-26**  25 min.  LO 1-3  M | **Incomplete Data on Creation of Subsidiary**  Students must calculate book value, reported amounts, reported shares, impact on balance sheet amounts. |
| **P1-27**  20 min.  LO 1-5  M | **Acquisition in Multiple Steps**  Students must prepare journal entries for the completion of the acquisition of additional shares of a previously owned company. |
| **P1-28**  15 min.  LO 1-5  M | **Journal Entries to Record a Business Combination**  Students must show the journal entries made to record a business combination in which the acquiring company issues shares of common stock. |
| **P1-29**  15 min.  LO 1-5  M | **Recording Business Combinations**  Students must show the journal entries made to record a business combination in which the acquiring company issues shares of common stock. |
| **P1-30**  30 min.  LO 1-5  E, Ws | **Business Combination with Goodwill**  Students must show the journal entry to be recorded by the acquiring company and the balance sheet following the business combination. |
| **P1-31**  15 min.  LO 1-5  M | **Bargain Purchase**  Students must show the journal entry to be made by the acquiring company in recording a business combination involving gain on bargain purchase. |
| **P1-32**  15 min.  LO 1-5  M | **Computation of Account Balances**  Calculation of liability balance and fair value is required with simultaneous consideration of potential goodwill impairment. |
| **P1-33**  25 min.  LO 1-5  H | **Goodwill Assigned to Multiple Reporting Units**  Calculation of goodwill and potential goodwill impairment for multiple reporting units in a company are required. |
| **P1-34**  15 min.  LO 1-5  M | **Journal Entries**  Students must show journal entries recorded by acquiring company for a business combination. Costs of combination must be considered. |
| **P1-35**  30 min.  LO 1-5  M, Ws | **Purchase at More than Book Value**  Students must show journal entries to record a business combination and prepare a balance sheet immediate after the business combination. |
| **P1-36**  25 min.  LO 1-5  M | **Business Combination**  Journal entries recorded by the acquiring company to record the business combination. Several account balances must be adjusted. |
| **P1-37**  30 min.  LO 1-5  H | **Combined Balance Sheet**  The balance sheet following the business combination is required. Stockholders' equity balances are required assuming three different levels of stock are issued by the acquiring company in completing the business combination. |
| **P1-38**  30 min.  LO 1-5  M | **Incomplete Data**  Balance sheet information for two separate entities and for the combined entity immediate after a business combination is given. Students must calculate the number of shares issued, market value of shares, fair value of inventory held by the acquired company, acquired company’s net assets, goodwill arising from the combination, retained earnings balance after combination, and depreciation expense for the first year on the acquired company’s depreciable assets. |
| **P1-39**  30 min.  LO 1-5  M | **Incomplete Data Following Purchase**  Balance sheet information for two separate entities and for the combined entity immediate after a business combination is given. Students must calculate the number and price of shares issued, the amount of cash paid as stock issuance costs, market value of shares issued on date of combination, cash paid for stock issue costs, market value of shares issued, the fair value of inventory and net assets, and the amount of goodwill to be reported. |
| **P1-40**  40 min.  LO 1-5  M | **Comprehensive Business Combination**  Students are given a comprehensive set of financial statements with book values and fair values. They are required to prepare all journal entries on the acquiring company’s books related to the business combination. Next they are asked to present the entries that would have been entered on the acquired company’s books. |

**OTHER RESOURCES**

**Chapter 1**

**Business Combination Illustration**

On January 1, 20X9, Aggressive Co. acquired all the common shares of Docile Corp. by issuing common shares. Aggressive Co. issued shares with a par value of $15,000 and a market value of $90,000 in completing the acquisition.



|  |  |  |
| --- | --- | --- |
|  | | |
| COMPUTATION OF GOODWILL | | |
|  | | |
| Fair Value of Shares issued by Aggressive Co. |  | $90,000 |
| Fair Value of Docile Corp. Assets | $150,000 |  |
| Fair Value of Docile Corp. Liabilities | (72,000) |  |
| Fair Value of Docile Corp. Net Assets |  | (78,000) |
| Goodwill |  | $12,000 |