

# Advanced Financial Accounting



# Advanced Financial Accounting

Seventh Edition

**Richard E. Baker**

*Northern Illinois University*

**Valdean C. Lembke**

*University of Iowa*

**Thomas E. King**

*Southern Illinois University at Edwardsville*

**Cynthia G. Jeffrey**

*Iowa State University*



Boston Burr Ridge, IL Dubuque, IA New York San Francisco St. Louis  
Bangkok Bogotá Caracas Kuala Lumpur Lisbon London Madrid Mexico City  
Milan Montreal New Delhi Santiago Seoul Singapore Sydney Taipei Toronto



## ADVANCED FINANCIAL ACCOUNTING

Published by McGraw-Hill/Irwin, a business unit of The McGraw-Hill Companies, Inc., 1221 Avenue of the Americas, New York, NY, 10020. Copyright © 2008 by The McGraw-Hill Companies, Inc. All rights reserved. No part of this publication may be reproduced or distributed in any form or by any means, or stored in a database or retrieval system, without the prior written consent of The McGraw-Hill Companies, Inc., including, but not limited to, in any network or other electronic storage or transmission, or broadcast for distance learning.

Some ancillaries, including electronic and print components, may not be available to customers outside the United States.

Portions of **FASB Statement No. 52**, "Foreign Currency Translation," copyright by the Financial Accounting Standards Board, 401 Merritt 7, PO Box 5116, Norwalk, CT 06856-5116, U.S.A., are reproduced with permission. Complete copies of this document are available from the FASB.

Material from the Uniform CPA Examination and Unofficial Answers, Copyright 1969, 1970, 1972, 1973, 1974, 1975, 1976, 1977, 1978, 1979, 1980, 1981, 1982, 1983, 1984, 1985, 1986, 1987, 1988, 1989, 1990, 1991, 1992, 1993, 1994, 1995, 1996, 1997, 1998, by the American Institute of Certified Public Accountants, is reprinted (or adapted) with permission.

Material from the Certified Management Accountants Examination, Copyright 1974, 1975, 1976, 1977, 1979, 1980, 1981, 1982, 1983, 1984, 1985, 1986, 1987, 1988, 1989, by the Institute of Certified Management Accountants, is reprinted (or adapted) with permission.

This book is printed on acid-free paper.

1 2 3 4 5 6 7 8 9 0 QPD/QPD 0 9 8 7

ISBN 978-0-07-352674-4

MHID 0-07-352674-6

Editorial director: *Stewart Mattson*

Editorial assistant: *Megan McFarlane*

Associate marketing manager: *Daniel Wiencek*

Project manager: *Harvey Yep*

Production supervisor: *Gina Hangos*

Lead designer: *Matthew Baldwin*

Supplement producer: *Christine Vaughan*

Senior media project manager: *Susan Lombardi*

Cover design: *Matthew Baldwin*

Cover image: © *Getty Images*

Typeface: *10.5/12 Times Roman*

Compositor: *Laserwords Private Limited*

Printer: *Quebecor World Dubuque Inc.*

#### Library of Congress Cataloging-in-Publication Data

Baker, Richard E.

Advanced financial accounting / Richard E. Baker, Valdean C. Lembke,

Thomas E. King.—7th ed.

p. cm.

Includes index.

ISBN-13: 978-0-07-352674-4 (alk. paper)

ISBN-10: 0-07-352674-6 (alk. paper)

I. Accounting. I. Lembke, Valdean C. II. King, Thomas E. III. Title.

HF5635.B165 2008

657'.046—dc22

2007000085

# About the Authors

## **Richard E. Baker**

Richard E. Baker is a member of the faculty at Northern Illinois University. His academic recognitions include being named the Ernst & Young Distinguished Professor of Accountancy at Northern Illinois University. In addition, he was 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 have been continuous over many years and include serving on the AAA's Executive Committee as the Director of Education of the AAA; as a member of the AAA's Council as the Chair of the Teaching and Curriculum Section; and previously as the President of the Midwest Region. His lengthy service to the Federation of Schools of Accountancy (FSA) includes the offices of the President, the Vice President, and the Secretary. Many of his extensive professional or academic organization committee service efforts have involved research in assessing teaching and learning outcomes, designing innovative curriculum models, developing meaningful measurement criteria for evaluating accounting programs, and continually integrating new electronic technology into the accounting classroom. Professor Baker has served as an Associate Editor for *Issues in Accounting Education* and previously served as a reviewer for this journal for several years. He also has served as an Associate Editor of *Advances in Accounting Education*. He has received numerous teaching awards at both the undergraduate and graduate levels and has been selected as the Illinois CPA Society's Outstanding Accounting Educator. 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 mergers and acquisitions. Professor Baker's major teaching areas include advanced financial accounting, financial theory, and international business management. He is a CPA and has taught advanced financial accounting topics in CPA Examination review courses.

## **Valdean C. Lembke**

Valdean C. Lembke has been a faculty member in the Department of Accounting at the University of Iowa for many years. He received his B.S. degree from Iowa State University and his MBA and Ph.D. from the University of Michigan. He has internal audit and public accounting experience. He has been active in the American Accounting Association, including service as President of the Midwest Region and Book Review Editor for *Issues in Accounting Education*. He was twice named recipient of the Gilbert P. Maynard Excellence in Accounting Instruction award. Professor Lembke has been actively involved in service to the Department of Accounting. He served two terms as department head and has been head of the Professional Program in Accounting. Professor Lembke has authored or coauthored articles in journals such as *The Accounting Review*; the *Journal of Accounting, Auditing and Finance*; the *Journal of Accountancy*; and the *Internal Auditor*. He also coauthored *Financial Accounting: A Decision-Making Approach*, an introductory accounting text, and a chapter on business combinations and consolidated financial statements in the *Accountant's Encyclopedia*. His teaching has been primarily in undergraduate and graduate coursework in financial accounting and in governmental and not-for-profit accounting. He has taught advanced financial accounting on a continuing basis.

## **Thomas E. King**

Thomas E. King is a member of the faculty of the School of Business at Southern Illinois University at Edwardsville. He received his B.S. degree from California State University, Northridge, and his MBA and Ph.D. from the University of California, Los Angeles. He is a CPA and received an Elijah Watt Sells Award and the Illinois gold medal for his scores on the Uniform CPA Examination. He has a number of years of business and consulting experience

and has taught for more than 30 years. Professor King coauthored with Valdean Lembke the chapter on business combinations and consolidated financial statements in the *Accountant's Encyclopedia*, and he has authored or coauthored numerous articles appearing in journals such as *The Accounting Review*; *Accounting Horizons*; the *Journal of Accountancy*; the *Journal of Accounting, Auditing and Finance*; the *Journal of Accounting Education*; and *Financial Executive*. He also coauthored *Financial Accounting: A Decision-Making Approach*, an introductory accounting text. Professor King has served on the editorial boards of *Advances in Accounting* and *Advances in Accounting Education* for a number of years. He has completed two terms on the Board of Governors of the St. Louis Chapter of the Institute of Internal Auditors, and he has been active in the Financial Executives Institute, the Institute of Management Accountants, and the Illinois CPA Society. Professor King has taught advanced financial accounting, along with other courses.

### **Cynthia G. Jeffrey**

Cynthia G. Jeffrey is an Associate Professor of Accounting in the College of Business at Iowa State University. She received her B.S. and M.S. at Iowa State University and her Ph.D. from the University of Minnesota. She is a CPA and a member of the AICPA, the American Accounting Association, and the Canadian Academic Accounting Association. Professor Jeffrey received the Graduate Teaching Award from Iowa State University in 2005 and was recognized as Teacher of the Year in 2000. She was Director of the Master of Accounting program from its inception in 1999 until 2004. Professor Jeffrey has authored or coauthored articles in journals such as *The Accounting Review*, the *Journal of Accounting, Auditing and Finance*, *Business Ethics Quarterly*, *Behavioral Research in Accounting*, *The International Journal of Accounting*, the *Asia-Pacific Journal of Accounting*, and *Issues in Accounting Education*. Professor Jeffrey is the editor of *Research on Professional Responsibility and Ethics in Accounting*. She teaches both graduate and undergraduate courses and her major teaching areas are financial accounting, financial accounting theory, and international accounting.

# Preface

The seventh 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 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 nonprofit 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 seventh edition of *Advanced Financial Accounting* continues to provide strong coverage of advanced accounting topics, as well as 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. The 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. 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 its 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 beliefs that clear presentation and comprehensive illustrations are essential to learning the sophisticated topics in an advanced accounting course. Key features of the seventh edition include:

- **A building block approach based on a strong conceptual foundation.** For each major topic area, students are provided with a thorough conceptual understanding before advancing to the procedures. The discussion begins with the fundamental concepts and why 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 advanced accounting. 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 only become familiar with one set of data and can then move more quickly through the subsequent discussions 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. However, two other methods—the cost method and the fully adjusted equity method—are fully discussed and illustrated 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 the topics included in this text. In recognition of time constraints, this 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.
- **Contemporary topical coverage.** Today’s dynamic business environment requires accountants to continually learn about new types of transactions, new technologies available to the profession, and new requirements and standards for accounting and financial reporting. This textbook integrates the most recent professional standards and includes cases and examples from current practice. For example, because of the importance of the Sarbanes-Oxley Act, coverage of SOX has been extended in this edition. Due to the significance, and notoriety, of special-purpose entities (SPEs) in recent years, coverage of this important topic has been included. Discussion of the FASB’s interpretation relating to variable-rate interest entities (VIEs) is included and illustrated along with a discussion and illustration of the consolidation of VIEs. The text also includes a discussion of the FASB’s deliberations and proposals relating to business combinations and important consolidation issues, such as the treatment of noncontrolling interests and full recognition of fair values and goodwill (entity approach). While the textbook reflects contemporary professional issues, it also continues to provide updated discussion and extensive illustrations of the continuing conceptual foundations for each of the topics. Students are presented with an abundance of current information and learning opportunities to see that the topics in their advanced financial accounting are a significant part of today’s profession of accountancy.
- **Extensive end-of-chapter materials.** A large number of questions, cases, exercises, and problems at the end of each chapter provides students an opportunity to solidify their understanding of the chapter material and assess their 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. These cases include Financial Accounting Research System (FARS) database searches, company data using the Internet, and Kaplan CPA Review simulations. The AICPA has identified five skills



to be examined as part of the CPA exam: (a) analysis, (b) judgment, (c) communication, (d) research, and (e) understanding. The end-of-chapter materials provide abundant opportunities for students to enhance those skills with realistic and real-world applications of advanced financial accounting topics.

## 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 textbook presents comprehensive examples and discussions of the accounting and financial reporting issues that accountants face. In this edition, discussions tied to the Peerless continuous case are easily identified by the company logos in the margin:



The following description explains how the text is organized and how continuing examples are used to demonstrate many of the topics:

### Business Combinations, Intercorporate Equity Investments, and Consolidation Concepts

Chapters 1 and 2 of the textbook introduce the issues of complex organizational structures and accounting for business combinations and intercorporate equity investments. Chapter 3 provides a conceptual foundation for the study of consolidated financial statements.

### Consolidation of Wholly Owned Subsidiaries

Chapter 4 initiates the story of Peerless Products Corporation, which purchases all of the stock of Special Foods Inc. and maintains Special Foods as a subsidiary. The consolidation workpaper is presented, with a discussion of both a simple workpaper as of the date of combination and a three-part workpaper for consolidation subsequent to acquisition. Basic consolidation procedures for consolidation at the date of combination and subsequent to combination are presented. The preparation of consolidated financial statements for Peerless Products and its wholly owned subsidiary Special Foods is illustrated for two years of combined operations.

### Consolidation of Less-than-Wholly Owned Subsidiaries

Chapter 5 builds on the consolidation concepts introduced in Chapters 3 and 4 with an examination of the complexities added by a parent acquiring less than 100 percent ownership of a subsidiary. The consolidation of less-than-wholly owned subsidiaries is illustrated for two years of operations by assuming that Peerless Products acquires 80 percent of Special Foods' stock.

### Intercompany Transactions

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

### 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 ownership in Special Foods by selling some of its stock investment in Special Foods 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. Comprehensive appendices are presented that 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 presents a discussion of 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. Coverage of the Sarbanes-Oxley Act is presented in this chapter so that students can gain some insight into this significant act.

## **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 of 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 needed by Alt to represent his constituents. Chapter 19 presents the accounting and financial reporting requirements for Sol City University and Sol City Community Hospital, along with several other nonprofit agencies located in Sol City.

## Corporation 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/baker7e](http://www.mhhe.com/baker7e) contains two supplemental chapters. The first, Accounting for Branch Operations, presents illustrations and discusses the issues of accounting and reporting 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 also the first partner brought into the Peerless Products partnership. These chapters include end-of-chapter material for which solutions may be obtained online by instructors.

## CHANGES FOR THE SEVENTH 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 revised to best illustrate and explore prior and new standards.

1. **Reorganization of consolidation foundation material.** The consolidation materials in the first section of the book have been extensively reorganized. The discussion of different theories of consolidation in Chapter 3 has been streamlined and a numerical example has been added to illustrate the effects of the different theories, including the FASB's proposed standards on combinations and consolidations. Because most subsidiaries are wholly owned, consolidation procedures for wholly owned subsidiaries are discussed before adding the complexity of less-than-wholly owned subsidiaries. Thus, Chapter 4 deals with the consolidation of wholly owned subsidiaries both at the date of acquisition and beyond. Most of the important aspects of consolidation are discussed in Chapter 4 in the context of wholly owned subsidiaries. Chapter 5 then builds on this foundation to discuss consolidation of majority-owned subsidiaries.
2. **Illustrations of proposed FASB standards on consolidation and combinations.** The FASB currently is moving toward the completion of projects proposing major changes in accounting for business combinations and the presentation of consolidated financial statements. Although the proposed standards are not yet finalized, they will, if adopted, have a significant impact on future practice. The FASB's proposals are included in the text in several ways. First, brief coverage of the proposed standards is integrated throughout the text when relevant topics are discussed. Second, a more detailed discussion of the proposed standards is provided in a separate section in Chapters 1, 3, and 5. Third, numerical examples are provided to illustrate the effects of implementing the proposed standards. For example, in Chapter 5, a full workpaper illustration of the preparation of consolidated financial statements under the proposed standards is presented. This illustration is extended on the text's Website, and additional illustrations are presented as well ([www.mhhe.com/baker7e](http://www.mhhe.com/baker7e)). End-of-chapter materials relating to the proposed standards have been included in the text.
3. **Increased coverage of the Sarbanes-Oxley Act.** The Sarbanes-Oxley Act (SOX) has had a profound impact on auditing and corporate governance. Chapter 14 provides an extensive overview and discussion of SOX, providing a background essential for accountants. Cases have been added for students to gain additional understanding of SOX.
4. **Integration of the Revised Uniform Partnership Act.** The model Revised Uniform Partnership Act (RUPA), or a significant adaptation, has now been adopted in about 40 states. Additional states are in the process of evaluating the impact of the RUPA on their states to determine which parts of the model RUPA they might adopt. Chapters 15 and 16 discuss and illustrate the essential provisions of RUPA.

5. **Increased focus on governmental and not-for-profit financial statements and disclosures.** Chapters 17 and 18 (on governmental entities) and Chapter 19 (on not-for-profit entities) have been updated to include recent GASB and FASB standards, and the discussion and end-of-chapter materials have been enhanced to provide students with more opportunities to understand how the accounting and reporting standards affect the financial statements and other elements of the entities' annual reports.
6. **More real-world examples throughout the text.** Additional real-world examples have been added throughout the chapters to illustrate the topics and to show students that the topics covered are important for accountants to understand and be able to apply in the dynamic business environment. These examples make it "real" for students.
7. **End-of-chapter materials have been significantly restructured.**
  - *New cases:* Real-world cases included in the end-of-chapter materials have been updated and a number of new ones added throughout the text. These cases provide students with a sense of relevancy, an opportunity to engage in online research, and a chance to practice formal writing.
  - *Kaplan CPA Review simulations:* Also introduced are a number of simulations of advanced financial accounting issues that use the framework by Kaplan CPA Review. Students can work the simulations online to gain experience on the presentation and operation of simulations that appear on the computerized CPA exam.
  - *Supplemental problems:* Some of the longer, more complex problems in some of the chapters have been moved to the textbook's Website ([www.mhhe.com/baker7e](http://www.mhhe.com/baker7e)) and are now presented as Supplemental Problems. Advanced financial accounting classes that wish to intensively explore the accounting and reporting requirements of a chapter's topics can access the Website and download this problem material. By moving some of the longer problems to the Website, the authors created space to add more real-world research cases, which are becoming increasingly important for advanced financial accounting courses.

## RETAINED FEATURES

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

1. The comprehensive continuous case approach has been retained because it provides students with 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 reflect recent FASB and GASB standards, as well as 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 continued.
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 are asked to use library or Internet research tools and materials in support of their answers. These cases require students to go beyond the computational level in addressing the topics in advanced financial accounting.
5. The study guide for the text is written by the authors of the text to ensure full integration and compatible presentation of the topics. The study guide for the seventh edition has

been revised to reflect all the updates and enhancements in the textbook as a result of the new GASB and FASB standards, and every effort has been made to provide a terrific learning tool for students.

6. Because advanced financial accounting 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 and cases requiring database research and written presentations 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 (0073210889)***

Written by the authors of 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/baker7e](http://www.mhhe.com/baker7e)), Student Edition***

- *Learning Objectives:* The online material for each chapter begins with the learning objective for that chapter. Students gain an overview of the importance to accountants of the topics covered in each chapter.
- *Online Quizzes:* Prepared by Amy Kaiser, interactive quizzes give students a variety of multiple-choice and true/false questions related to each chapter for self-evaluation.
- *Excel Worksheets:* Prepared by Harlan Fuller, 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 Alex Clifford, copies of the Microsoft PowerPoint Slides® are available by chapter to facilitate note-taking and review.
- *Supplemental Problems:* Additional problem materials for many of the chapters are available online to enhance students' learning of the topics in the chapters. These supplemental problems tend to be longer and present a more comprehensive fact situation in order to broaden students' understanding of the topics in the chapters.
- *Supplemental Chapters:* Two chapters are available online for students wishing extended learning in regard to: (a) accounting for home office and branch operations; and (b) accounting and reporting for estates and trusts. Cases, exercises, and problems are also available for these two chapters.
- *PowerWeb:* This feature is a unique Website that extends the learning experience beyond the core textbook and includes the following learning aids:
  - Current readings.
  - Study tips and self-quizzes.
  - Links to related sites.
  - Web research guides.
  - Access to Northern Light Search Engine, providing Internet access to additional articles.

## For the Instructor

### *Instructor's Resource CD-ROM (0073210897)*

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

- *Solutions Manual*: Created by the authors, solutions are provided for all questions, cases, exercises, and problems in the text. Solutions are carefully explained and logically presented. Answers for 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 Beth Woods, 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 Leonard Stokes, 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 each chapter's topics. The test items are closely coordinated with the text to ensure consistency.

### **Online Learning Center (URL: [www.mhhe.com/baker7e](http://www.mhhe.com/baker7e)), 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.
- *Supplemental Problems*: Downloadable additional exercises and problems are provided for many chapters in both the Student Edition and the Instructor Edition. Instructors can assign these additional exercises and problems to broaden their students' understanding of the topics in the chapters. The Instructor Edition includes downloadable solutions to those supplemental exercises and problems.
- *Supplemental Chapters*: Two chapters are available online: (a) accounting for home office and branch operations; and (b) accounting and reporting for estates and trusts. Cases, exercises, and problems are also available for these two chapters and the Instructor Edition includes solutions to those end-of-chapter items.
- *Instructor Updates*: The Online Learning Center contains timely discussions and illustrations of major accounting or financial reporting issues under deliberation by standard-setting bodies. Instructors can choose to download these updates and share them with their students.
- *PowerWeb* delivers to instructors and students the latest news and developments pertinent to the course:
  - Access to current articles related to advanced financial accounting.
  - Updates.
  - 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 online class delivery when using products such as WebCT or Blackboard.
- *Page-Out* is McGraw-Hill's Course Management System that provides a "point and click" course Website tool.



# Acknowledgments

This text includes the thoughts and contributions of many individuals, and we wish to express our sincere appreciation to them. First, and foremost, we thank all the students in our advanced accounting classes, from whom we have learned so much. In many respects, this text is an outcome of the learning experiences we have shared with our students. Second, we wish to thank the many outstanding teachers we have had in our own educational programs, from whom we learned the joy of learning. We are indebted to our colleagues in advanced accounting for helping us reach our goal of writing the best possible advanced financial accounting text. We appreciate the many valuable comments and suggestions from the instructors who used earlier editions of the text. Their comments and suggestions have contributed to making this text a more effective learning tool. We especially wish to thank: C. Richard Baker, Adelphi University; Jean C. Bedard; Mark Bettner, Bucknell University; Bruce Bradford, Fairfield University; Bobby Carmichael, Texas A&M; Charles Christianson, Luther College; Steve Czarsty, Mary Washington College; David Doran, Pennsylvania State University, Erie; John Engstrom, Northern Illinois University; Wayne Higley, Buena Vista College; Sharron Hoffmans, University of Texas, El Paso; James Hopkins, Morningside College; Gordon Hosch, University of New Orleans; David Karmon, Central Michigan University; Aubrey Kosson; James Lahey, Northern Illinois University; May H. Lo, Western New England College; Mary Maury, St. John's University; Ralph McQuade, Jr., Bentley College; David Meeting, Cleveland State University; Philip Meyer, Boston University; Jon Nance, Southwest Missouri State University; Scott Newman, Western State College of Colorado; Larry Prober, Rider University; Terence Reilly, Albright College; Max Rexroad, Illinois State University; Andrew Rosman, University of Connecticut; Eugene Rozanski, Illinois State University; Norlin Reuschhoff, University of Notre Dame; Victoria Rymer, University of Maryland at College Park; Nancy Starnes, Southern Illinois University, Edwardsville; Pam Smith, Northern Illinois University; James Stice, Brigham Young University; Mack Tennyson, University of Charleston; Stuart Webster, University of Wyoming; and Scott Whisenant, University of Houston.

We also wish to thank John R. Simon, Northern Illinois University, for his assistance in revising the end-of-chapter material in several chapters of the text. Appreciation is expressed to Wendy A. Duffy for her development of FARS cases for several of the chapters. We also thank Lisa Enfinger, for her work in accuracy checking, as well as the supplements authors: Leonard Stokes, for the creation of the Test Bank; Harlan Fuller, for creation of the Excel Templates; Alex Clifford for development of the Microsoft PowerPoint Slides<sup>®</sup>; Amy Kaiser, for creation of the Online Quizzes; and Beth Woods, for creation of the Instructor's Resource Manual. Typing assistance was provided by Margaret Berg, Northern Illinois University. We especially want to thank Lois Lembke for her many efforts on our Solutions Manual.

We are grateful for the assistance and direction of the McGraw-Hill/Irwin team: Stewart Mattson, Steve DeLancey, Dan Wiencek, Robin Reed, Megan McFarlane, Harvey Yen, Gina Hangos, Jess Kotic, Susan Lombardi, Ira Roberts, Matthew Baldwin, and Christine Vaughan, who all worked hard to champion our book through the production process.

Permission has been received from the Institute of Certified Management Accountants of the Institute of Management Accountants to use questions and/or unofficial answers from past CMA examinations. We appreciate the cooperation of the American Institute of Certified Public Accountants for providing permission to adapt and use materials from past Uniform CPA Examinations. We also thank Kaplan CPA Review for providing its online framework for advanced financial accounting students so they might gain important experience with the types of simulations included on the Uniform CPA Exam.

Above all, we extend our deepest appreciation to our families, who continue to provide the encouragement and support necessary for this project.

*Richard E. Baker*  
*Valdean C. Lembke*  
*Thomas E. King*  
*Cynthia G. Jeffrey*

# Brief Contents

- |           |   |     |           |   |             |
|-----------|---|-----|-----------|---|-------------|
| <b>1</b>  | Intercorporate Acquisitions and Investments in Other Entities                     | 1   | <b>12</b> | Multinational Accounting: Translation of Foreign Entity Statements            | 572         |
| <b>2</b>  | Reporting Intercorporate Interests  | 49  | <b>13</b> | Segment and Interim Reporting   | 630         |
| <b>3</b>  | The Reporting Entity and Consolidated Financial Statements                        | 92  | <b>14</b> | SEC Reporting   | 679         |
| <b>4</b>  | Consolidation of Wholly Owned Subsidiaries  | 134 | <b>15</b> | Partnerships: Formation, Operation, and Changes in Membership                 | 706         |
| <b>5</b>  | Consolidation of Less-than-Wholly Owned Subsidiaries                              | 196 | <b>16</b> | Partnerships: Liquidation   | 755         |
| <b>6</b>  | Intercompany Transfers of Services and Noncurrent Assets                          | 260 | <b>17</b> | Governmental Entities: Introduction and General Fund Accounting               | 793         |
| <b>7</b>  | Intercompany Inventory Transactions   | 325 | <b>18</b> | Governmental Entities: Special Funds and Government-wide Financial Statements | 852         |
| <b>8</b>  | Intercompany Indebtedness   | 371 | <b>19</b> | Not-for-Profit Entities   | 919         |
| <b>9</b>  | Consolidation Ownership Issues  | 416 | <b>20</b> | Corporations in Financial Difficulty  | 989         |
| <b>10</b> | Additional Consolidation Reporting Issues   | 463 |           | <b>INDEX</b>  | <b>1033</b> |
| <b>11</b> | Multinational Accounting: Foreign Currency Transactions and Financial Instruments | 500 |           |   |             |



# Contents

## Chapter 1

### Intercorporate Acquisitions and Investments in Other Entities 1

The Development of Complex Business Structures	2
<i>Enterprise Expansion</i>	2
<i>Organizational Structure and Business Objectives</i>	2
<i>Organizational Structure, Acquisitions, and Ethical Considerations</i>	2
Business Expansion and Forms of Organizational Structure	4
<i>Expansion from Within</i>	4
<i>Expansion through Business Combinations</i>	4
<i>Frequency of Business Combinations</i>	5
<i>Complex Organizational Structures</i>	6
<i>Organizational Structure and Financial Reporting</i>	6
Creating Business Entities	7
Business Combinations	9
<i>Forms of Business Combinations</i>	9
<i>Methods of Effecting Business Combinations</i>	10
<i>Valuation of Business Entities</i>	11
Accounting for Business Combinations	13
<i>Determining the Purchase Price</i>	13
<i>Combination Effected through Purchase of Net Assets</i>	14
<i>Combination Effected through Purchase of Stock</i>	19
<i>Financial Reporting Subsequent to a Business Combination</i>	19
<i>Disclosure Requirements</i>	20
Additional Considerations in Accounting for Business Combinations	21
<i>Accounting and Reporting Methods</i>	21
<i>Proposed Changes from the FASB</i>	22
Summary of Key Concepts	23
Key Terms	23
Questions	23
Cases	24
Exercises	27
Problems	38

## Chapter 2

### Reporting Intercorporate Interests 49

Accounting for Investments in Common Stock	49
The Cost Method	51
<i>Accounting Procedures under the Cost Method</i>	51
<i>Declaration of Dividends in Excess of Earnings since Acquisition</i>	51

<i>Acquisition at Interim Date</i>	53
<i>Changes in the Number of Shares Held</i>	53
The Equity Method	53
<i>Use of the Equity Method</i>	54
<i>Investor's Equity in the Investee</i>	54
<i>Recognition of Income</i>	54
<i>Recognition of Dividends</i>	55
<i>Carrying Amount of the Investment</i>	55
<i>Acquisition at Interim Date</i>	56
<i>Difference between Cost of Investment and Underlying Book Value</i>	56
<i>Changes in the Number of Shares Held</i>	60
The Cost and Equity Methods Compared	61
Interests Other than Investments in Common Stock	63
<i>Investments in Partnerships</i>	63
<i>Nonequity Interests in Other Entities</i>	65
Additional Considerations Relating to the Equity Method	66
<i>Determination of Significant Influence</i>	66
<i>Unrealized Intercompany Profits</i>	66
<i>Additional Requirements of APB 18</i>	67
<i>Investor's Share of Other Comprehensive Income</i>	68
<i>Tax Allocation Procedures</i>	68
<i>Accounting for Investments in Subsidiaries</i>	71
Summary of Key Concepts	71
Key Terms	71
Questions	72
Cases	72
Exercises	74
Problems	83

## Chapter 3

### The Reporting Entity and Consolidated Financial Statements 92

Usefulness of Consolidated Financial Statements	93
Limitations of Consolidated Financial Statements	93
Subsidiary Financial Statements	94
Consolidated Financial Statements: Concepts and Standards	94
<i>Traditional View of Control</i>	94
<i>Indirect Control</i>	95
<i>Ability to Exercise Control</i>	95
<i>Differences in Fiscal Periods</i>	95
<i>Changing Concept of the Reporting Entity</i>	96
Overview of the Consolidation Process	96
The Consolidation Process Illustrated	97

<i>The Consolidated Entity</i>	98
<i>Mechanics of the Consolidation Process</i>	101
Noncontrolling Interest	102
Combined Financial Statements	103
Special-Purpose and Variable Interest Entities	103
<i>Off-Balance Sheet Financing</i>	104
<i>Qualifying Special-Purpose Entities</i>	104
<i>Variable Interest Entities</i>	105
Additional Considerations—Different Approaches to Consolidation	107
<i>Theories of Consolidation</i>	107
<i>Comparison of Alternative Theories</i>	108
<i>Current Practice</i>	110
<i>Future Practice and Proposed Changes from the FASB</i>	110
Summary of Key Concepts	111
Key Terms	112
<b>APPENDIX 3A</b>	
<b>Consolidation of Variable Interest Entities</b>	<b>112</b>
Questions	113
Cases	114
Exercises	117
Problems	126
<b>Chapter 4</b>	
<b>Consolidation of Wholly Owned Subsidiaries</b>	<b>134</b>
Consolidation Procedures	134
Consolidation Workpapers	135
<i>Workpaper Format</i>	135
<i>Nature of Eliminating Entries</i>	135
Preparation of Consolidated Balance Sheet Immediately following Acquisition of Full Ownership	136
<i>Full Ownership Purchased at Book Value</i>	137
<i>Full Ownership Purchased at More than Book Value</i>	139
<i>Treatment of a Positive Differential</i>	141
<i>Illustration of Treatment of Debit Differential</i>	143
<i>Full Ownership Purchased at Less than Book Value</i>	145
<i>Illustration of Treatment of Credit Differential</i>	146
<i>Ownership Purchased at More than Book Value and Less than Fair Value</i>	148
Consolidation Subsequent to Acquisition	148
<i>Consolidated Net Income</i>	149
<i>Consolidated Retained Earnings</i>	149
<i>Workpaper Format</i>	150
Consolidation Subsequent to Acquisition—100 Percent Ownership Purchased at Book Value	152
<i>Year of Combination</i>	152
<i>Second and Subsequent Years of Ownership</i>	155
<i>Consolidated Net Income and Retained Earnings</i>	157
Consolidation Subsequent to Acquisition—100 Percent Ownership Purchased at More than Book Value	158
<i>Year of Combination</i>	159
<i>Second Year of Ownership</i>	164
Intercompany Receivables and Payables	167
Push-Down Accounting	168
Summary of Key Concepts	169
Key Terms	169
<b>APPENDIX 4A</b>	
<b>Push-Down Accounting Illustrated</b>	<b>169</b>
Questions	171
Cases	172
Exercises	174
Problems	184
<b>Chapter 5</b>	
<b>Consolidation of Less-than-Wholly Owned Subsidiaries</b>	<b>196</b>
Effect of a Noncontrolling Interest	196
<i>Consolidated Net Income</i>	196
<i>Consolidated Retained Earnings</i>	197
<i>Workpaper Format</i>	198
Preparation of Consolidated Balance Sheet Immediately following Acquisition of Controlling Ownership	198
Consolidation Subsequent to Acquisition of Controlling Ownership	201
<i>Year of Combination</i>	202
<i>Second Year of Ownership</i>	206
Discontinuance of Consolidation	210
Treatment of Other Comprehensive Income	210
<i>Modification of the Consolidation Workpaper</i>	211
<i>Adjusting Entry Recorded by Subsidiary</i>	212
<i>Adjusting Entry Recorded by Parent Company</i>	212
<i>Consolidation Workpaper—Second Year following Combination</i>	212
<i>Consolidation Procedures</i>	212
<i>Consolidation Workpaper—Comprehensive Income in Subsequent Years</i>	213
Additional Considerations	216
<i>Subsidiary Valuation Accounts at Acquisition</i>	216
<i>Negative Retained Earnings of Subsidiary at Acquisition</i>	217
<i>Other Stockholders' Equity Accounts</i>	217
<i>Subsidiary's Disposal of Differential-Related Assets</i>	217
<i>Changes Proposed by the FASB</i>	218
Summary of Key Concepts	219
Key Terms	220
<b>APPENDIX 5A</b>	
<b>Consolidation and the Cost Method</b>	<b>220</b>
<b>APPENDIX 5B</b>	
<b>Illustration of the FASB's Proposed Changes</b>	<b>226</b>
Questions	230
Cases	231

Exercises	233
Problems	246

## Chapter 6

### Intercompany Transfers of Services and Noncurrent Assets 260

Overview of the Consolidated Entity	260
<i>Elimination of Intercompany Transfers</i>	260
<i>Elimination of Unrealized Profits and Losses</i>	261
Intercompany Transfers of Services	263
Intercompany Transfers of Land	264
<i>Overview of the Profit Elimination Process</i>	264
<i>Assignment of Unrealized Profit Elimination</i>	265
<i>Downstream Sale</i>	267
<i>Upstream Sale</i>	270
<i>Eliminating Unrealized Profits after the First Year</i>	274
<i>Subsequent Disposition of Asset</i>	275
Intercompany Transfers of Depreciable Assets	277
<i>Downstream Sale</i>	277
<i>Change in Estimated Life of Asset upon Transfer</i>	285
<i>Upstream Sale</i>	286
<i>Asset Transfers before Year-End</i>	292
Intercompany Transfers of Amortizable Assets	292
Summary of Key Concepts	292
Key Terms	293

#### APPENDIX 6A

### Intercompany Transfers of Noncurrent Assets—Fully Adjusted Equity Method and Cost Method 293

Questions	302
Cases	303
Exercises	305
Problems	312

## Chapter 7

### Intercompany Inventory Transactions 325

General Overview	325
<i>Transfers at Cost</i>	325
<i>Transfers at a Profit or Loss</i>	326
<i>Effect of Type of Inventory System</i>	326
Downstream Sale of Inventory	326
<i>Resale in Period of Intercorporate Transfer</i>	327
<i>Resale in Period following Intercorporate Transfer</i>	328
<i>Inventory Held Two or More Periods</i>	334
Upstream Sale of Inventory	334
<i>Basic Equity-Method Entries—20X1</i>	335
<i>Consolidation Workpaper—20X1</i>	335
<i>Consolidated Net Income—20X1</i>	337
<i>Basic Equity-Method Entries—20X2</i>	337
<i>Consolidation Workpaper—20X2</i>	338
<i>Consolidated Net Income—20X2</i>	338
Additional Considerations	339
<i>Sale from One Subsidiary to Another</i>	339

<i>Costs Associated with Transfers</i>	340
<i>Lower of Cost or Market</i>	340
<i>Sales and Purchases before Affiliation</i>	341
Summary of Key Concepts	341

#### APPENDIX 7A

### Intercompany Inventory Transactions—Fully Adjusted Equity Method and Cost Method 341

Questions	345
Cases	346
Exercises	348
Problems	357

## Chapter 8

### Intercompany Indebtedness 371

Consolidation Overview	371
Bond Sale Directly to an Affiliate	373
<i>Transfer at Par Value</i>	373
<i>Transfer at a Discount or Premium</i>	373
Bonds of Affiliate Purchased from a Nonaffiliate	376
<i>Purchase at Book Value</i>	376
<i>Purchase at an Amount Less than Book Value</i>	376
<i>Purchase at an Amount Greater than Book Value</i>	389
Summary of Key Concepts	390
Key Terms	390

#### APPENDIX 8A

### Intercompany Indebtedness—Fully Adjusted Equity Method and Cost Method 390

Questions	395
Cases	396
Exercises	398
Problems	402

## Chapter 9

### Consolidation Ownership Issues 416

Subsidiary Preferred Stock Outstanding	416
<i>Consolidation with Subsidiary Preferred Stock Outstanding</i>	416
<i>Subsidiary Preferred Stock Held by Parent</i>	419
<i>Subsidiary Preferred Stock with Special Provisions</i>	420
<i>Illustration of Subsidiary Preferred Stock with Special Features</i>	421
Changes in Parent Company Ownership	423
<i>Parent's Purchase of Additional Shares from Nonaffiliate</i>	423
<i>Parent's Sale of Subsidiary Shares to Nonaffiliate</i>	424
<i>Subsidiary's Sale of Additional Shares to Nonaffiliate</i>	428
<i>Subsidiary's Sale of Additional Shares to Parent</i>	431
<i>Subsidiary's Purchase of Shares from Nonaffiliate</i>	432
<i>Subsidiary's Purchase of Shares from Parent</i>	434
Complex Ownership Structures	435
<i>Multilevel Ownership and Control</i>	435
<i>Reciprocal or Mutual Ownership</i>	440

Subsidiary Stock Dividends	445
<i>Illustration of Subsidiary Stock Dividends</i>	445
<i>Impact on Subsequent Periods</i>	446
Summary of Key Concepts	447
Key Terms	447
Questions	447
Cases	448
Exercises	449
Problems	456
<b>Chapter 10</b>	
<b>Additional Consolidation Reporting Issues</b>	<b>463</b>
Consolidated Statement of Cash Flows	463
<i>Preparation of a Consolidated Cash Flow Statement</i>	463
<i>Consolidated Cash Flow Statement Illustrated</i>	464
<i>Consolidated Cash Flow Statement—Direct Method</i>	466
Consolidation Following an Interim Acquisition	468
<i>Parent Company Entries</i>	469
<i>Consolidation Workpaper</i>	469
Consolidation Income Tax Issues	472
<i>Allocation of Tax Expense When a Consolidated Return Is Filed</i>	472
<i>Tax Effects of Unrealized Intercompany Profit Eliminations</i>	473
Consolidated Earnings per Share	476
<i>Computation of Diluted Consolidated Earnings per Share</i>	477
<i>Computation of Consolidated Earnings per Share Illustrated</i>	478
Summary of Key Concepts	480
Key Terms	480
Questions	480
Cases	481
Exercises	483
Problems	489
<b>Chapter 11</b>	
<b>Multinational Accounting: Foreign Currency Transactions and Financial Instruments</b>	<b>500</b>
The Accounting Issues	501
Foreign Currency Exchange Rates	502
<i>The Determination of Exchange Rates</i>	502
<i>Direct versus Indirect Exchange Rates</i>	502
<i>Changes in Exchange Rates</i>	504
<i>Spot Rates versus Current Rates</i>	507
<i>Forward Exchange Rates</i>	507
Foreign Currency Transactions	507
<i>Foreign Currency Import and Export Transactions</i>	509
Managing International Currency Risk with Foreign Currency Forward Exchange Financial Instruments	512

<i>Derivatives Designated as Hedges</i>	513
<i>Forward Exchange Contracts</i>	515
<i>Case 1: Managing an Exposed Foreign Currency Net Asset or Liability Position: Not a Designated Hedging Instrument</i>	517
<i>Case 2: Hedging an Unrecognized Foreign Currency Firm Commitment: A Foreign Currency Fair Value Hedge</i>	522
<i>Case 3: Hedging a Forecasted Foreign Currency Transaction: A Foreign Currency Cash Flow Hedge</i>	526
<i>Case 4: Speculation in Foreign Currency Markets</i>	528
<i>Foreign Exchange Matrix</i>	531
Additional Considerations	531
<i>A Note on Measuring Hedge Effectiveness</i>	531
<i>Interperiod Tax Allocation for Foreign Currency Gains (Losses)</i>	532
<i>Hedges of a Net Investment in a Foreign Entity</i>	532
Summary of Key Concepts	533
Key Terms	533
<b>APPENDIX 11A</b>	
<b>Illustration of Valuing Forward Exchange Contracts with Recognition for the Time Value of Money</b>	<b>533</b>
<b>APPENDIX 11B</b>	
<b>Use of Other Financial Instruments by Multinational Companies</b>	<b>536</b>
Questions	550
Cases	550
Exercises	552
Problems	563
<b>Chapter 12</b>	
<b>Multinational Accounting: Translation of Foreign Entity Statements</b>	<b>572</b>
Differences in Accounting Principles	572
Determining the Functional Currency	574
<i>Functional Currency Designation in Highly Inflationary Economies</i>	576
Translation versus Remeasurement of Foreign Financial Statements	577
Translation of Functional Currency Statements into the Reporting Currency of the U.S. Company	578
<i>Financial Statement Presentation of Translation Adjustment</i>	579
<i>Illustration of Translation and Consolidation of a Foreign Subsidiary</i>	580
<i>Noncontrolling Interest of a Foreign Subsidiary</i>	590
Remeasurement of the Books of Record into the Functional Currency	590
<i>Statement Presentation of Remeasurement Gain or Loss</i>	591
<i>Illustration of Remeasurement of a Foreign Subsidiary</i>	592
<i>Summary of Translation versus Remeasurement</i>	593

Foreign Investments and Unconsolidated Subsidiaries	00
<i>Liquidation of a Foreign Investment</i>	00
Hedge of a Net Investment in a Foreign Subsidiary	00
Disclosure Requirements	00
Additional Considerations in Accounting for Foreign Operations and Entities	00
<i>Remeasurement Case: Subsequent Consolidation Workpaper</i>	00
<i>Proof of Remeasurement Exchange Gain</i>	00
<i>Statement of Cash Flows</i>	00
<i>Lower-of-Cost-or-Market Inventory Valuation under Remeasurement</i>	00
<i>Intercompany Transactions</i>	00
<i>Income Taxes</i>	00
<i>Translation When a Third Currency Is the Functional Currency</i>	00
Summary of Concepts	00
Key Terms	00
Questions	00
Cases	00
Exercises	00
Problems	00

## **Chapter 13**

### **Segment and Interim Reporting 630**

Reporting for Segments	630
Segment Reporting Accounting Issues	630
Information about Operating Segments	631
<i>Defining Reportable Segments</i>	632
<i>Comprehensive Disclosure Test</i>	638
<i>Reporting Segment Information</i>	638
Enterprisewide Disclosures	639
<i>Information about Products and Services</i>	640
<i>Information about Geographic Areas</i>	640
<i>Information about Major Customers</i>	641
Interim Financial Reporting	642
The Format of the Interim Financial Report	642
Accounting Issues	643
<i>Discrete versus Integral View of Interim Reporting</i>	643
<i>Accounting Pronouncements on Interim Reporting</i>	643
Reporting Standards for Interim Income Statements	644
<i>Revenue</i>	644
<i>Cost of Goods Sold and Inventory</i>	644
<i>All Other Costs and Expenses</i>	649
<i>Accounting for Income Taxes in Interim Periods</i>	650
<i>Disposal of a Segment or Extraordinary, Unusual, Infrequently Occurring, and Contingent Items</i>	654
Accounting Changes in Interim Periods	655
<i>Change in an Accounting Principle (Retrospective Application)</i>	655

<i>Change in an Accounting Estimate (Current and Prospective Application)</i>	655
<i>Change in a Reporting Entity (Retrospective Application)</i>	656

Summary of Key Concepts	656
Key Terms	656
Questions	656
Cases	657
Exercises	662
Problems	671

## **Chapter 14**

### **SEC Reporting 679**

History of Securities Regulation	679
Electronic Data Gathering, Analysis, and Retrieval (EDGAR) System	680
International Harmonization of Accounting Standards for Public Offerings	680
Securities and Exchange Commission	681
<i>Organizational Structure of the Commission</i>	681
<i>Laws Administered by the SEC</i>	682
<i>The Regulatory Structure</i>	682
Issuing Securities: The Registration Process	685
<i>The Registration Statement</i>	686
<i>SEC Review and Public Offering</i>	686
<i>Accountants' Legal Liability in the Registration Process</i>	687
Periodic Reporting Requirements	687
<i>Accountants' Legal Liability in Periodic Reporting</i>	690
Foreign Corrupt Practices Act of 1977	690
Sarbanes-Oxley Act of 2002	691
<i>Title I: Public Company Accounting Oversight Board</i>	691
<i>Title II: Auditor Independence</i>	691
<i>Title III: Corporate Responsibility</i>	692
<i>Title IV: Enhanced Financial Disclosures</i>	692
<i>Title V: Analyst Conflicts of Interest</i>	693
<i>Title VI: Commission Resources and Authority</i>	693
<i>Title VII: Studies and Reports</i>	693
<i>Title VIII: Corporate and Criminal Fraud Accountability</i>	693
<i>Title IX: White Collar Crime Penalty Enhancements</i>	693
<i>Title X: Sense of Congress regarding Corporate Tax Returns</i>	693
<i>Title XI: Corporate Fraud Accountability</i>	694
Disclosure Requirements	694
<i>Management Discussion and Analysis</i>	694
<i>Pro Forma Disclosures</i>	695
Summary of Key Concepts	695
Key Terms	696
Questions	696
Cases	696
Exercises	700



**Chapter 15****Partnerships: Formation, Operation, and Changes in Membership 706**

Nature of Partnership Entity	706
<i>Legal Regulation of Partnerships</i>	707
<i>Definition of a Partnership</i>	707
<i>Formation of a Partnership</i>	707
<i>Other Major Characteristics of Partnerships</i>	708
Accounting for the Formation of a Partnership	710
<i>Illustration of Accounting for Partnership Formation</i>	710
Accounting for Operations of a Partnership	711
<i>Partners' Accounts</i>	712
Allocating Profit or Loss to Partners	713
<i>Illustrations of Profit Allocation</i>	713
<i>Multiple Bases of Profit Allocation</i>	717
<i>Special Profit Allocation Methods</i>	717
Partnership Financial Statements	718
Changes in Membership	718
<i>General Concepts to Account for a Change in Membership in the Partnership</i>	719
<i>New Partner Purchases an Interest</i>	720
<i>New Partner Invests in Partnership</i>	721
<i>Determining a New Partner's Investment Cost</i>	732
<i>Dissociation of a Partner from the Partnership</i>	733
Summary	735
Key Terms	736

**APPENDIX 15A****Tax Aspects of a Partnership 736****APPENDIX 15B****Joint Ventures 737**

Questions	739
Cases	740
Exercises	741
Problems	748

**Chapter 16****Partnerships: Liquidation 755**

Overview of Partnership Liquidations	755
<i>Dissociation, Dissolution, Winding Up, and Liquidation of a Partnership</i>	755
Lump-Sum Liquidations	757
<i>Realization of Assets</i>	757
<i>Expenses of Liquidation</i>	757
<i>Illustration of Lump-Sum Liquidation</i>	757
Installment Liquidations	762
<i>Illustration of Installment Liquidation</i>	762
<i>Cash Distribution Plan</i>	766
Additional Considerations	769
<i>Incorporation of a Partnership</i>	769
Summary of Key Concepts	770
Key Terms	770

**APPENDIX 16A****Partners' Personal Financial Statements 770**

Questions	773
Cases	774
Exercises	776
Problems	786

**Chapter 17****Governmental Entities: Introduction and General Fund Accounting 793**

History of Governmental Accounting	794
Major Concepts of Governmental Accounting	795
<i>Elements of Financial Statements</i>	795
<i>Expendability of Resources versus Capital Maintenance Objectives</i>	796
<i>Definitions and Types of Funds</i>	796
Financial Reporting of Governmental Entities	798
<i>Fund Financial Statements: Governmental Funds</i>	799
Measurement Focus and Basis of Accounting (MFBA)	802
<i>Basis of Accounting—Governmental Funds</i>	802
<i>Basis of Accounting—Proprietary Funds</i>	806
<i>Basis of Accounting—Fiduciary Funds</i>	806
Budgetary Aspects of Governmental Operations	806
<i>Recording the Operating Budget</i>	807
Accounting for Expenditures	808
<i>The Expenditure Process</i>	808
<i>Classification of Expenditure Transactions and Accounts</i>	810
<i>Outstanding Encumbrances at the End of the Fiscal Period</i>	810
<i>Expenditures for Inventory</i>	813
<i>Accounting for Fixed Assets</i>	815
<i>Long-Term Debt and Capital Leases</i>	816
<i>Investments</i>	816
Interfund Activities	817
(1) <i>Interfund Loans</i>	817
(2) <i>Interfund Services Provided and Used</i>	817
(3) <i>Interfund Transfers</i>	818
(4) <i>Interfund Reimbursements</i>	819
Overview of Accounting and Financial Reporting for the General Fund	819
Comprehensive Illustration of Accounting for the General Fund	819
<i>Adoption of the Budget</i>	820
<i>Property Tax Levy and Collection</i>	822
<i>Other Revenue</i>	823
<i>Expenditures</i>	824
<i>Acquisition of Capital Asset</i>	824
<i>Interfund Activities</i>	825
<i>Adjusting Entries</i>	826
<i>Closing Entries</i>	826
<i>General Fund Financial Statement Information</i>	828

Summary of Key Concepts	829
Key Terms	830
Questions	830
Cases	831
Exercises	832
Problems	841

## Chapter 18

### Governmental Entities: Special Funds and Government-wide Financial Statements 852

Governmental Funds Worksheets	853
Special Revenue Funds	857
Capital Projects Funds	857
<i>Illustration of Transactions</i>	857
<i>Financial Statement Information for the Capital Projects Fund</i>	860
Debt Service Funds	860
<i>Illustration of Transactions</i>	861
<i>Financial Statement Information for the Debt Service Fund</i>	863
Permanent Funds	863
<i>Illustration of Transactions</i>	863
Governmental Funds Financial Statements	864
Enterprise Funds	867
<i>Illustration of Transactions</i>	868
<i>Financial Statements for the Proprietary Funds</i>	870
Internal Service Funds	873
<i>Illustration of Transactions</i>	874
<i>Financial Statements for Internal Service Funds</i>	875
Trust Funds	875
<i>Illustration of Private-Purpose Trust Fund</i>	877
Agency Funds	878
<i>Illustration of Transactions in an Agency Fund</i>	878
The Government Reporting Model	878
<i>Four Major Issues</i>	878
<i>Government Financial Reports</i>	880
<i>Government-wide Financial Statements</i>	881
<i>Reconciliation Schedules</i>	883
<i>Budgetary Comparison Schedule</i>	885
<i>Management's Discussion and Analysis</i>	886
<i>Certain Financial Statement Note Disclosures</i>	886
<i>Other Financial Report Items</i>	888
<i>Interim Reporting</i>	888
<i>Auditing Governmental Entities</i>	888
Additional Considerations	888
<i>Special-Purpose Governmental Entities</i>	888
<i>Financial Reporting for Pensions and OPEB Plans</i>	889
Summary of Key Concepts	890
Key Terms	891
<b>APPENDIX 18A</b>	
<b>Other Government Entities—Public School Systems and the Federal Government</b>	<b>891</b>
Questions	892

Cases	893
Exercises	894
Problems	905

## Chapter 19

### Not-for-Profit Entities 919

Financial Reporting for Private, Not-for-Profit Entities	919
<i>Important FASB Standards for Not-for-Profit Entities</i>	921
Colleges and Universities	923
<i>Special Conventions of Revenue and Expenditure Recognition</i>	923
<i>Board-Designated Funds</i>	924
<i>Public Colleges and Universities</i>	924
<i>Private Colleges and Universities</i>	924
Health Care Providers	926
<i>Hospital Accounting</i>	929
<i>Financial Statements for a Not-for-Profit Hospital</i>	930
<i>Comprehensive Illustration of Hospital Accounting and Financial Reporting</i>	934
<i>Temporarily Restricted Funds</i>	942
<i>Summary of Hospital Accounting and Financial Reporting</i>	946
Voluntary Health and Welfare Organizations	946
<i>Accounting for a VHWO</i>	947
<i>Financial Statements for a VHWO</i>	947
<i>Summary of Accounting and Financial Reporting for VHWOs</i>	957
Other Not-for-Profit Entities	957
<i>Accounting for ONPOs</i>	957
<i>Financial Statements of ONPOs</i>	958
<i>Summary of Accounting and Financial Reporting for ONPOs</i>	960
Summary of Key Concepts	961
Key Terms	961
Questions	961
Cases	962
Exercises	965
Problems	975
<b>Chapter 20</b>	
<b>Corporations in Financial Difficulty 989</b>	
Courses of Action	989
<i>Nonjudicial Actions</i>	990
<i>Judicial Actions</i>	991
Chapter 11 Reorganizations	992
<i>Fresh Start Accounting</i>	993
<i>Plan of Reorganization</i>	995
<i>Illustration of a Reorganization</i>	995
Chapter 7 Liquidations	1002
Classes of Creditors	1003
<i>Secured Creditors</i>	1003
<i>Creditors with Priority</i>	1003

<i>General Unsecured Creditors</i>	1003	Questions	1021
<i>Statement of Affairs</i>	1005	Cases	1021
Additional Considerations	1006	Exercises	1023
<i>Trustee Accounting and Reporting</i>	1006	Problems	1028
Summary of Key Concepts	1011		
Key Terms	1012		
<b>APPENDIX 20A</b>		<b>Index</b>	<b>1033</b>
<b>Accounting for Impaired Loans and Debt</b>			
<b>Restructuring Arrangements</b>	1012		