

# Advanced Accounting 11th Edition Chapter 5 Solutions

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## Chapter 2

### STOCK INVESTMENTS — INVESTOR ACCOUNTING AND REPORTING

#### Answers to Questions

- 1 Only the investor's accounts are affected when outstanding stock is acquired from existing stockholders. The investor records the investment at its cost. Since the investee company is not a party to the transaction, its accounts are not affected.  
Both investor and investee accounts are affected when unissued stock is acquired directly from the investee. The investor records the investment at its cost and the investee adjusts its asset and owners' equity accounts to reflect the issuance of previously unissued stock.
- 2 Goodwill arising from an equity investment of 20 percent or more is not recorded separately from the investment account. Under the equity method, the investment is presented on one line of the balance sheet in accordance with the one-line consolidation concept.
- 3 Dividends received from earnings accumulated before an investment is acquired are treated as decreases in the investment account balance under the fair value/cost method. Such dividends are considered a return of a part of the original investment.
- 4 The equity method of accounting for investments increases the investment account for the investor's share of the investee's income and decreases it for the investor's share of the investee's losses and for dividends received from the investee. In addition, the investment and investment income accounts are adjusted for amortization of any investment cost-book value differentials related to the interest acquired. Adjustments to the investment and investment income accounts are also needed for unrealized profits and losses from transactions between the investor and investee companies. A fair value adjustment is optional under SFAS No. 159.
- 5 The equity method is referred to as a one-line consolidation because the investment account is reported on one line of the investor's balance sheet and investment income is reported on one line of the investor's income statement (except when the investee has extraordinary gains/losses or gains/losses from discontinued operations). In addition, the investment income is computed such that the parent company's income and stockholders' equity are equal to the consolidated net income and consolidated stockholders' equity that would result if the statements of the investor and investee were consolidated.
- 6 If the equity method of accounting is applied correctly, the income of the parent company will generally equal the controlling interest share of consolidated net income. If the subsidiary is 100% owned by the parent, the parent's net income under the equity method will equal the consolidated net income of the parent and its subsidiary.
- 7 The difference in the equity method and consolidation lies in the detail reported, but not in the amount of income reported. The equity method reports investment income on one line of the income statement whereas the details of revenues and expenses are reported in the consolidated income statement.
- 8 The investment account balance of the investor will equal underlying book value of the investee if (a) the equity method is correctly applied, (b) the investment was acquired at book value which was equal to fair value, the pooling method was used, or the cost-book value differentials have all been amortized or written off as impairment losses, and (c) there have been no intercompany transactions between the affiliated companies that have created investment account-book value differences.
- 9 The investment account balance must be converted from the cost to the equity method when acquisitions increase the interest held to 20 percent or more. The amount of the adjustment is the difference between the investment income reported under the cost method in prior years and the income that would have been reported if the equity method of accounting had been used. The offsetting account in the journal entry is

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Advanced Accounting 11th Edition Chapter 5 Solutions provides a comprehensive analysis of complex accounting topics, particularly focusing on consolidations and accounting for business combinations. This chapter is crucial for students and professionals alike, as it delves into the nitty-gritty of how entities unite, the financial implications of these unions, and the proper accounting practices that must be adhered to. This article will explore the key concepts, practical illustrations, and problem-solving strategies presented in Chapter 5, helping readers to navigate through advanced accounting challenges.

# Understanding Business Combinations

Business combinations occur when two or more entities come together to form a single entity. This section outlines the various forms of business combinations and the accounting principles that govern them.

## Types of Business Combinations

1. Merger: When two companies combine to form a new entity, with one of the original companies ceasing to exist.
2. Acquisition: One company purchases another, which may remain a separate entity.
3. Consolidation: A new entity is formed from the two or more combining companies, which cease to exist.

## Accounting Framework for Business Combinations

The accounting for business combinations is primarily governed by the Financial Accounting Standards Board (FASB) and the International Financial Reporting Standards (IFRS). Key aspects include:

- Purchase Method: Under this method, the acquiring company allocates the purchase price to the identifiable assets and liabilities of the acquired company.
- Goodwill Calculation: Goodwill arises when the purchase price exceeds the fair value of net identifiable assets. It represents intangible assets that cannot be separately identified.

## Consolidation Procedures

Once a business combination occurs, the next step is to consolidate the financial statements of the combined entities. This section will guide you through the consolidation process, highlighting the essential steps.

## Steps in the Consolidation Process

1. Identify the Acquirer: Determine which entity is the acquiring company in the transaction.
2. Determine the Acquisition Date: Establish the date on which control of the acquired company transfers to the acquirer.
3. Identify and Measure the Assets Acquired and Liabilities Assumed: Assess the fair values of all identifiable assets and liabilities.
4. Calculate Goodwill or Gain from a Bargain Purchase: Goodwill is calculated as the excess of the purchase price over the fair value of the net identifiable assets.
5. Prepare Consolidated Financial Statements: Combine the financial statements of the

acquirer and the acquired company, eliminating intercompany transactions.

## Common Challenges in Accounting for Business Combinations

Accounting for business combinations can be complex, presenting several challenges that professionals must navigate. Understanding these challenges can aid in developing effective solutions.

### Challenges Faced

- Valuation of Assets and Liabilities: Accurately assessing the fair value of all acquired assets and assumed liabilities can be difficult, particularly for intangible assets.
- Goodwill Impairment: Assessing whether goodwill has been impaired requires ongoing evaluation and analysis, which can be subjective.
- Intercompany Transactions: Eliminating transactions between the parent and subsidiary can be complicated and may require detailed disclosures.
- Disclosure Requirements: Meeting the extensive disclosure requirements set forth by FASB and IFRS can be overwhelming, especially for complex transactions.

## Practical Illustrations and Solutions

Chapter 5 of Advanced Accounting provides various practical problems and solutions that illustrate the concepts of business combinations and consolidations. Here, we will review a couple of illustrative examples to clarify these concepts.

### Example 1: Acquisition of a Subsidiary

Scenario: Company A acquires 80% of Company B for \$1,200,000. The fair value of Company B's identifiable net assets at acquisition is \$1,000,000.

Solution Steps:

1. Determine Non-controlling Interest (NCI):
  - $\text{NCI} = \text{Fair Value of Net Assets} \times \text{Percentage not Acquired}$
  - $\text{NCI} = \$1,000,000 \times 20\% = \$200,000$
2. Calculate Goodwill:
  - $\text{Total Consideration} = \$1,200,000$
  - $\text{Total Fair Value of Net Assets} = \$1,000,000$
  - $\text{Goodwill} = \text{Total Consideration} - \text{Fair Value of Net Assets} + \text{NCI}$
  - $\text{Goodwill} = \$1,200,000 - \$1,000,000 + \$200,000 = \$400,000$

### 3. Consolidated Balance Sheet:

- Assets = \$1,000,000 (acquired) + Goodwill \$400,000
- Liabilities = Amount of liabilities assumed

## Example 2: Bargain Purchase

Scenario: Company C acquires Company D for \$800,000, with the fair value of identifiable net assets totaling \$1,000,000.

### Solution Steps:

#### 1. Calculate Gain from Bargain Purchase:

- Gain = Fair Value of Net Assets - Purchase Price
- Gain = \$1,000,000 - \$800,000 = \$200,000

#### 2. Recording the Transaction:

- The gain from the bargain purchase is recorded in the income statement as a gain on acquisition.

## Conclusion

In summary, Chapter 5 of Advanced Accounting 11th Edition provides valuable insights into the complexities of accounting for business combinations and consolidations. By understanding the types of business combinations, mastering the consolidation procedures, and addressing common challenges, accounting professionals can navigate this intricate field with confidence. The practical examples and solutions offered in the chapter further illustrate the application of these concepts, making it an essential resource for anyone looking to deepen their understanding of advanced accounting practices. As you continue your studies or professional development in this area, consider these principles and challenges, and apply them to real-world scenarios for a well-rounded comprehension of advanced accounting.

## Frequently Asked Questions

### What are the key topics covered in Chapter 5 of Advanced Accounting 11th Edition?

Chapter 5 primarily addresses consolidations, including the acquisition method, the treatment of minority interests, and the preparation of consolidated financial statements.

### How does the acquisition method impact financial

## **statements in consolidations?**

The acquisition method requires the acquirer to recognize the identifiable assets acquired and liabilities assumed at their fair values, which affects the balance sheet and can lead to goodwill recognition.

## **What is the significance of non-controlling interests in Chapter 5?**

Non-controlling interests represent the portion of equity in a subsidiary not owned by the parent company, and their treatment is essential for accurate consolidated financial reporting.

## **Can you explain the difference between a statutory merger and a statutory consolidation?**

A statutory merger involves one company absorbing another, while a statutory consolidation creates a new entity, with both original companies ceasing to exist.

## **What are some common challenges faced when preparing consolidated financial statements?**

Common challenges include eliminating intercompany transactions, accurately assessing fair values of acquired assets and liabilities, and dealing with non-controlling interests.

## **How does Chapter 5 address intercompany transactions?**

Chapter 5 emphasizes that intercompany transactions must be eliminated in the consolidation process to avoid overstating revenues and expenses.

## **What role does goodwill play in the consolidation process discussed in Chapter 5?**

Goodwill represents the excess of the purchase price over the fair value of identifiable net assets acquired, and it must be tested for impairment in subsequent periods.

## **How can students effectively solve problems related to Chapter 5 solutions?**

Students can effectively solve problems by practicing with sample exercises, utilizing the step-by-step problem-solving approach outlined in the chapter, and reviewing solutions for understanding.

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