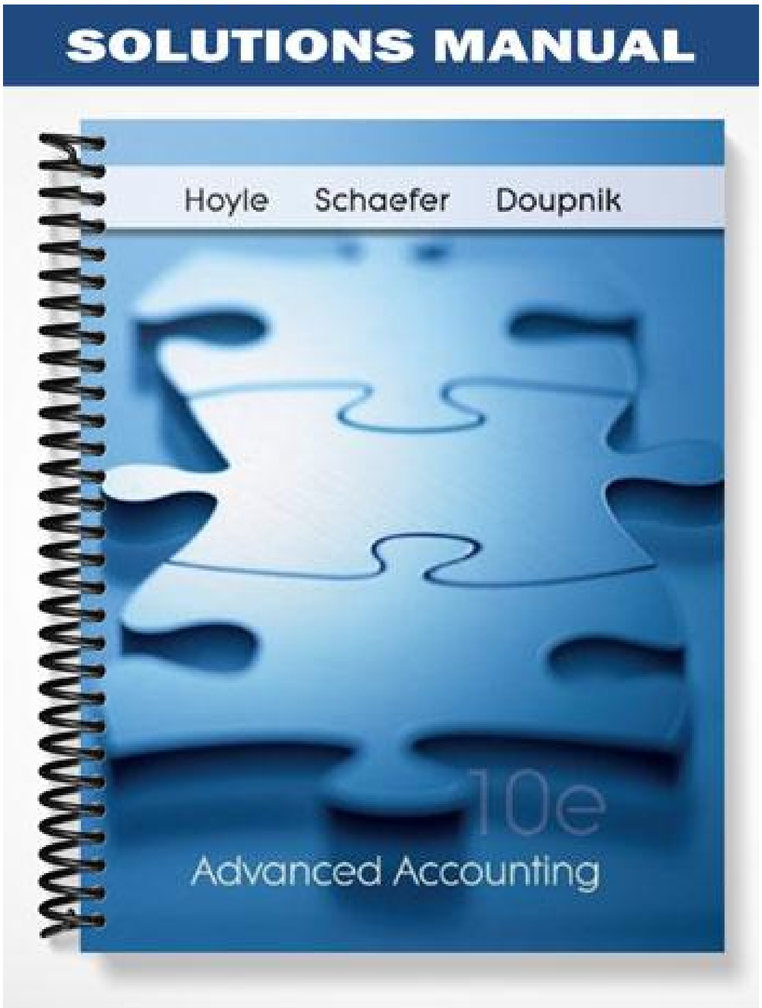
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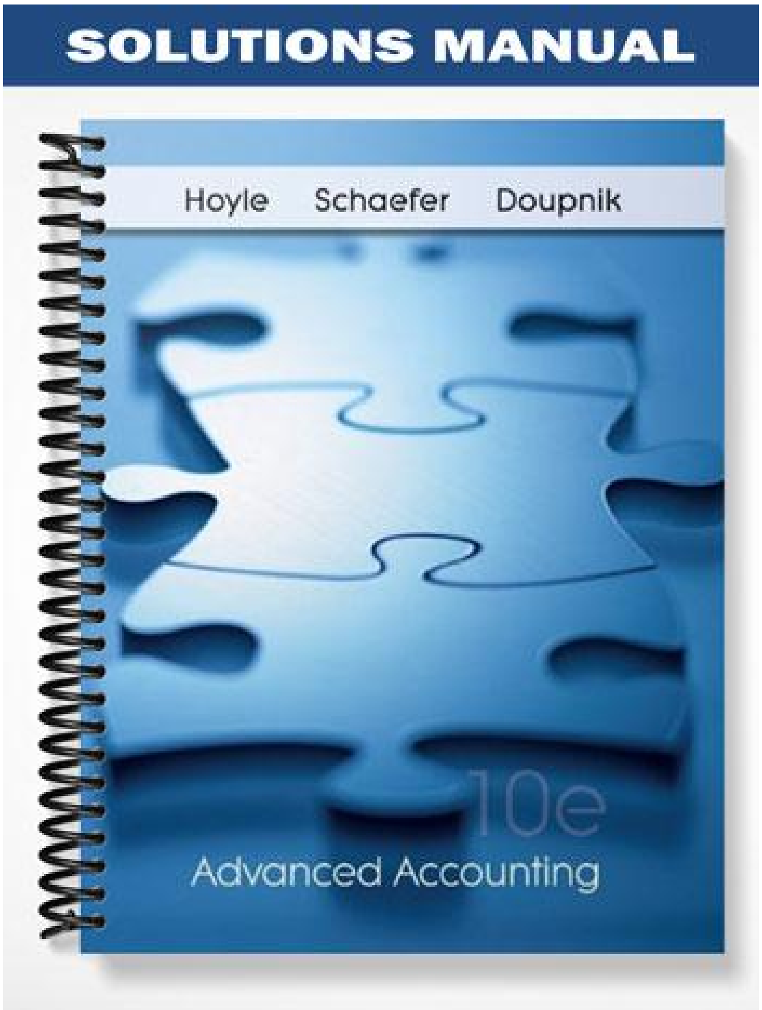
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CHAPTER 2
CONSOLIDATION OF FINANCIAL INFORMATION

Major changes have occurred for financial reporting for business combinations beginning in 2009. These changes are documented FASB ASC Topic 805, “Business Combinations” and Topic 810, “Consolidation.” These standards require the acquisition method which emphasizes acquisition-date fair values for recording all combinations.

In this chapter, we first provide coverage of expansion through corporate takeovers and an overview of the consolidation process. Then we present the acquisition method of accounting for business combinations followed by limited coverage of the purchase method and pooling of interests provided in a separate sections.

Chapter Outline

I. Business combinations and the consolidation process
   A. A business combination is the formation of a single economic entity, an event that occurs whenever one company gains control over another
   B. Business combinations can be created in several different ways
      1. Statutory merger—only one of the original companies remains in business as a legally incorporated enterprise.
         a. Assets and liabilities can be acquired with the seller then dissolving itself as a corporation.
         b. All of the capital stock of a company can be acquired with the assets and liabilities then transferred to the buyer followed by the seller’s dissolution.
      2. Statutory consolidation—assets or capital stock of two or more companies are transferred to a newly formed corporation
      3. Acquisition by one company of a controlling interest in the voting stock of a second. Dissolution does not take place; both parties retain their separate legal incorporation.
   C. Financial information from the members of a business combination must be consolidated into a single set of financial statements representing the entire economic entity.
      1. If the acquired company is legally dissolved, a permanent consolidation is produced on the date of acquisition by entering all account balances into the financial records of the surviving company.
      2. If separate incorporation is maintained, consolidation is periodically simulated whenever financial statements are to be prepared. This process is carried out through the use of worksheets and consolidation entries.

II. The Acquisition Method
   A. The acquisition method replaced the purchase method. For combinations resulting in complete ownership, it is distinguished by four characteristics.

1. All assets acquired and liabilities assumed in the combination are recognized and measured at their individual fair values (with few exceptions).
2. The fair value of the consideration transferred provides a starting point for valuing and recording a business combination.
   a. The consideration transferred includes cash, securities, and contingent performance obligations.
   b. Direct combination costs are not considered as part of the fair value of the consideration transferred for the acquired firm and are expensed as incurred.
   c. Stock issuance costs are recorded as a reduction in paid-in capital and are not considered to be a component of the consideration transferred.
   d. The fair value of any noncontrolling interest also adds to the valuation of the acquired firm and is covered beginning in Chapter 4 of the text.
3. Any excess of the fair value of the consideration transferred over the net amount assigned to the individual assets acquired and liabilities assumed is recognized by the acquirer as goodwill.
4. Any excess of the net amount assigned to the individual assets acquired and liabilities assumed over the fair value of the consideration transferred is recognized by the acquirer as a "gain on bargain purchase."

B. Current accounting standards require that in-process research and development acquired in a business combination be recognized as an asset at its acquisition-date fair value.

III. The Purchase Method

A. The purchase method was applicable for business combinations occurring for fiscal years beginning prior to December 15, 2008. It was distinguished by three characteristics.
1. One company was clearly in a dominant role as the purchasing party
2. A bargained exchange transaction took place to obtain control over the second company
3. A historical cost figure was determined based on the acquisition price paid
   a. The cost of the acquisition included any direct combination costs.
   b. Stock issuance costs were recorded as a reduction in paid-in capital and are not considered to be a component of the acquisition price.

B. Purchase method procedures where dissolution of the acquired company took place
1. The assets and liabilities being obtained were recorded by the buyer at fair value as of the date of acquisition
2. Any portion of the payment made in excess of the fair value of these assets and liabilities was attributed to an intangible asset commonly referred to as goodwill.
3. If the price paid was below the fair value of the assets and liabilities, the accounts of the acquired company were still recorded at fair value except that the values of certain noncurrent assets were reduced in total by the excess cost. If these

values were not great enough to absorb the entire reduction, an extraordinary gain was recognized.

C. Purchase method where separate incorporation of all parties was maintained.
   1. Consolidation figures were the same as when dissolution took place.
   2. A worksheet was normally utilized to simulate the consolidation process so that financial statements can be produced periodically.

IV. The Pooling of Interest Method (*prohibited for combinations after June 2002*)

A. A pooling of interests is formed by the uniting of the ownership interests of two companies through the exchange of equity securities. The characteristics of a pooling are fundamentally different from either the purchase or acquisition methods.
   1. Neither party was truly viewed as an acquiring company.
   2. Precise cost figures stemming from the exchange of securities were difficult to ascertain.
   3. The transaction affected the stockholders rather than the companies.

   Prior to the pooling prohibition, business combinations meeting twelve criteria established by the Accounting Principles Board (in its *Opinion 16*) were accounted for as a pooling of interests. If even one of the twelve was not satisfied, the combination was automatically viewed as a purchase.

B. Pooling of interests where dissolution occurred
   1. Because of the nature of a pooling, determination of an acquisition price was not relevant
      a. Since no acquisition price was computed, all direct costs of creating the combination were expensed immediately.
      b. In addition, new goodwill arising from the combination was never recognized in a pooling of interests. Similarly, no valuation adjustments were recorded for any of the assets or liabilities combined.
   2. The book values of the two companies were simply brought together to produce a set of consolidated financial records. A pooling was viewed as affecting the owners rather than the two companies.
   3. The results of operations reported by both parties were combined on a retroactive basis as if the companies had always been together.
   4. Controversy historically surrounded the pooling of interests method
      a. Any cost figures indicated by the exchange transaction that created the combination were ignored.
      b. Income balances previously reported were altered since operations were combined on a retroactive basis.
      c. Reported net income was usually higher in subsequent years than in a purchase since no goodwill or valuation adjustments were recognized which require amortization.

C. A pooling of interests where separate incorporation is maintained also combined the book values of the companies for periodic reporting purposes but the process is carried out on a worksheet.

Answers to Questions

1. A business combination is the process of forming a single economic entity by the uniting of two or more organizations under common ownership. The term also refers to the entity that results from this process.

2. (1) A statutory merger is created whenever two or more companies come together to form a business combination and only one remains in existence as an identifiable entity. This arrangement is often instituted by the acquisition of substantially all of an enterprise's assets. (2) a statutory merger can also be produced by the acquisition of a company's capital stock. This transaction is labeled a statutory merger if the acquired company transfers its assets and liabilities to the buyer and then legally dissolves as a corporation. (3) A statutory consolidation results when two or more companies transfer all of their assets or capital stock to a newly formed corporation. The original companies are being "consolidated" into the new entity. (4) A business combination is also formed whenever one company gains control over another through the acquisition of outstanding voting stock. Both companies retain their separate legal identities although the common ownership indicates that only a single economic entity exists.

3. Consolidated financial statements represent accounting information gathered from two or more separate companies. This data, although accumulated individually by the organizations, is brought together (or consolidated) to describe the single economic entity created by the business combination.

4. Companies that form a business combination will often retain their separate legal identities as well as their individual accounting systems. In such cases, internal financial data continues to be accumulated by each organization. Separate financial reports may be required for outside shareholders (a noncontrolling interest), the government, debt holders, etc. This information may also be utilized in corporate evaluations and other decision making. However, the business combination must periodically produce consolidated financial statements encompassing all of the companies within the single economic entity. A worksheet is used to organize and structure this process. The worksheet allows for a simulated consolidation to be carried out on a regular, periodic basis without affecting the financial records of the various component companies.

5. Several situations can occur in which the fair value of the 50,000 shares being issued might be difficult to ascertain. These examples include:
   - The shares may be newly issued (if Jones has just been created) so that no accurate value has yet been established;
   - Jones may be a closely held corporation so that no fair value is available for its shares;
   - The number of newly issued shares (especially if the amount is large in comparison to the quantity of previously outstanding shares) may cause the price of the stock to fluctuate widely so that no accurate fair value can be determined during a reasonable period of time;
   - Jones' stock may have historically experienced drastic swings in price. Thus, a quoted figure at any specific point in time may not be an adequate or representative value for long-term accounting purposes.

6. For combinations resulting in complete ownership, the acquisition method allocates the fair value of the consideration transferred to the separately recognized assets acquired and liabilities assumed based on their individual fair values.

7. The revenues and expenses (both current and past) of the **parent** are included within reported figures. However, the revenues and expenses of the subsidiary are only consolidated from the date of the acquisition forward. The operations of the subsidiary are only applicable to the business combination if earned subsequent to its creation.
8. Morgan's additional purchase price may be attributed to many factors: expected synergies between Morgan's and Jennings' assets, favorable earnings projections, competitive bidding to acquire Jennings, etc. In general however, under the acquisition method, any amount paid by the parent company in excess of the fair values of the subsidiary's net assets is reported as goodwill.
9. Under the acquisition method, in the vast majority of cases the assets acquired and liabilities assumed in a business combination are recorded at their fair values. If the fair value of the consideration transferred (including any contingent consideration) is less than the total net fair value assigned to the assets acquired and liabilities assumed, then an ordinary gain on bargain purchase is recognized for the difference.
10. Shares issued are recorded at fair value as if the stock had been sold and the money obtained used to acquire the subsidiary. The Common Stock account is recorded at the par value of these shares with any excess amount attributed to additional paid-in capital.
11. Under the acquisition method, direct combination costs are not considered part of the fair value of the consideration transferred and thus are not included in the purchase price. These direct combination costs are allocated to expense in the period in which they occur. Stock issue costs are treated under the acquisition method in the same way as under the purchase method, i.e., as a reduction of APIC.

Answers to Acquisition Method Problems

1. D

2. B

3. D

4. B

5. A

6. A

7. B

8. C

9. B

Consideration transferred (fair value)	**$800,000**
Fair value of *identifiable* assets	

Cash	$150,000	
A/R	140,000	
Software	320,000	
In-process R&D	200,000	
Liabilities	(130,000)	
Fair value of net *identifiable* assets acquired		680,000
Goodwill		$120,000

10. C Atkins records new shares at fair value

Value of shares issued (51,000 × $3)	$153,000
Par value of shares issued (51,000 × $1)	51,000
Additional paid-in capital (new shares)	$102,000
Additional paid-in capital (existing shares)	90,000
Consolidated additional paid-in capital	$192,000

At the acquisition date, the parent makes no change to retained earnings.

11. B

Consideration transferred (fair value)	$400,000
Book value of subsidiary (assets minus liabilities)	(300,000)
Fair value in excess of book value	100,000
Allocation of excess fair over book value identified with specific accounts:	
Inventory	30,000
Patented technology	20,000
Buildings and equipment	25,000
Long-term liabilities	10,000
Goodwill	$15,000

12. A Only the subsidiary's post-acquisition income is included in consolidated totals.

13. a. An intangible asset acquired in a business combination is recognized as an asset apart from goodwill if it arises from contractual or other legal rights (regardless of whether those contractual or legal rights are transferable or separable from the acquired enterprise or from other rights and obligations). If an intangible asset does not arise from contractual or other legal rights, it shall be recognized as an asset apart from goodwill only if it is separable, that is, it is capable of being separated or divided from the acquired enterprise and sold, transferred, licensed, rented, or exchanged (regardless of whether there is an intent to do so). An intangible asset that cannot be sold, transferred, licensed, rented, or exchanged individually is considered separable if it can be sold, transferred, licensed, rented, or exchanged with a related contract, asset, or liability.

b.
- **Trademarks—usually meet both the separability and legal/contractual criteria.**
- **A customer list—usually meets the separability criterion.**
- **Copyrights on artistic materials—usually meet both the separability and legal/contractual criteria.**
- **Agreements to receive royalties on leased intellectual property—usually meet the legal/contractual criterion.**
- **Unpatented technology—may meet the separability criterion if capable of being sold even if in conjunction with a related contract, asset, or liability.**

14. (12 minutes) (Journal entries to record a merger—acquired company dissolved)

Inventory	600,000	
Land	990,000	
Buildings	2,000,000	
Customer relationships	800,000	
Goodwill	690,000	
Accounts payable		80,000
Common stock		40,000
Additional paid-in capital		960,000
Cash		4,000,000
Combination expenses	42,000	
Cash		42,000
Additional paid-in capital	25,000	
Cash		25,000

15. (12 minutes) (Journal entries to record a bargain purchase—acquired company dissolved)

Inventory	600,000	
Land	990,000	
Buildings	2,000,000	
Customer relationships	800,000	
Accounts payable		80,000
Cash		4,200,000
Gain on bargain purchase		110,000
Combination expenses	42,000	
Cash		42,000

16. (15 Minutes) (Consolidated balances)

In acquisitions, the fair values of the subsidiary's assets and liabilities are consolidated (there are a limited number of exceptions). Goodwill is reported at $80,000, the amount that the $760,000 consideration transferred exceeds the $680,000 fair value of Sol's net assets acquired.

- **Inventory = $670,000 (Padre's book value plus Sol's fair value)**
- **Land = $710,000 (Padre's book value plus Sol's fair value)**
- **Buildings and equipment = $930,000 (Padre's book value plus Sol's fair value)**
- **Franchise agreements = $440,000 Padre's book value plus Sol's fair value)**
- **Goodwill = $80,000 (calculated above)**
- **Revenues = $960,000 (only parent company operational figures are reported at date of acquisition)**
- **Additional Paid-in Capital = $265,000 (Padre's book value adjusted for stock issue less stock issuance costs)**
- **Expenses = $940,000 (only parent company operational figures plus acquisition-related costs are reported at date of acquisition)**
- **Retained Earnings, 1/1 = $390,000 (Padre's book value)**

17. (20 Minutes) (Determine selected consolidated balances)

Under the acquisition method, the shares issued by Wisconsin are recorded at fair value:

Investment in Badger (value of debt and shares issued)	**900,000**	
Common stock (par value)		**150,000**
Additional paid-in capital (excess over par value)		**450,000**
Liabilities		**300,000**

The payment to the broker is accounted for as an expense. The stock issue cost is a reduction in additional paid-in capital.

Professional services expense	**30,000**	
Additional paid-in capital	**40,000**	
Cash		**70,000**

Allocation of Acquisition-Date Excess Fair Value:

Consideration transferred (fair value) for Badger Stock	**$900,000**
Book Value of Badger, 6/30	**770,000**
Fair Value in Excess of Book Value	**$130,000**
Excess fair value (undervalued equipment).....................	**100,000**

Excess fair value (overvalued patented technology)	**(20,000)**
Goodwill	**$50,000**

CONSOLIDATED BALANCES:

- **Net income (adjusted for combination expenses. The figures earned by the subsidiary prior to the takeover are not included) .... $ 210,000**
- **Retained Earnings, 1/1 (the figures earned by the subsidiary prior to the takeover are not included).................................. 800,000**
- **Patented Technology (the parent's book value plus the fair value of the subsidiary) 1,180,000**
- **Goodwill (computed above) 50,000**
- **Liabilities (the parent's book value plus the fair value of the subsidiary's debt plus the debt issued by the parent in acquiring the subsidiary) 1,210,000**
- **Common Stock (the parent's book value after recording the newly-issued shares) 510,000**
- **Additional Paid-in Capital (the parent's book value after recording the two entries above).................................. 680,000**

18. (20 minutes) (Preparation of a consolidated balance sheet)*

PINNACLE COMPANY AND CONSOLIDATED SUBSIDIARY STRATA
Worksheet for a Consolidated Balance Sheet
January 1, 2011

	Pinnacle	Strata	Adjust. & Elim.		Consolidated
Cash	433,000	122,000			555,000
Accounts receivable	1,210,000	283,000			1,493,000
Inventory	1,235,000	350,000			1,585,000
Investment in Strata	3,200,000	0		(S) 2,600,000	
				(A) 600,000	0
Buildings (net)	5,572,000	1,845,000	(A) 300,000		7,717,000
Licensing agreements	0	3,000,000		(A) 100,000	2,900,000
Goodwill	350,000	0	(A) 400,000		750,000
Total assets	12,000,000	5,600,000			15,000,000
Accounts payable	(300,000)	(375,000)			(675,000)
Long-term debt	(2,700,000)	(2,625,000)			(5,325,000)
Common stock	(3,000,000)	(1,000,000)	(S) 1,000,000		(3,000,000)
APIC	0	(500,000)	(S) 500,000		0
Retained earnings	(6,000,000)	(1,100,000)	(S) 1,100,000		(6,000,000)
Total liab. & equities	(12,000,000)	(5,600,000)			(15,000,000)

***Although this solution uses a worksheet to compute the consolidated amounts, the problem does not require it.**

19. (50 Minutes) (Determine consolidated balances for a bargain purchase.)

a. Marshall's acquisition of Tucker represents a bargain purchase because the fair value of the net assets acquired exceeds the fair value of the consideration transferred as follows:

Fair value of net assets acquired	**$515,000**
Fair value of consideration transferred	**400,000**
Gain on bargain purchase	**$115,000**

In a bargain purchase, the acquisition is recorded at the fair value of the net assets acquired instead of the fair value of the consideration transferred (an exception to the general rule).

Prior to preparing a consolidation worksheet, Marshall records the three transactions that occurred to create the business combination.

Investment in Tucker	**515,000**	
Long-term liabilities.................................		**200,000**
Common stock (par value).......................		**20,000**
Additional paid-in capital		**180,000**
Gain on bargain purchase		**115,000**

(To record liabilities and stock issued for Tucker acquisition fair value)

19. ***(continued)***

Combination expenses	**30,000**	
Cash		**30,000**

(to record payment of combination fees)

Additional paid-in capital....................................	**12,000**	
Cash		**12,000**

(To record payment of stock issuance costs)

Marshall's trial balance is adjusted for these transactions (as shown in the worksheet that follows).

Next, the fair of the $400,000 investment is allocated:

Consideration transferred at fair value...................................	**$400,000**
Book value (assets minus liabilities or total stockholders' equity)..	**460,000**
Book value in excess of consideration transferred	**(60,000)**

Allocation to specific accounts based on fair value:

Inventory		**5,000**
Land	**20,000**	
Buildings		**30,000**
Gain on bargain purchase (excess net asset fair value over consideration transferred)		**$(115,000)**

CONSOLIDATED TOTALS

- **Cash = $38,000. Add the two book values less acquisition and stock issue costs**
- **Receivables = $360,000. Add the two book values.**
- **Inventory = $505,000. Add the two book values plus the fair value adjustment**
- **Land = $400,000. Add the two book values plus the fair value adjustment.**
- **Buildings = $670,000. Add the two book values plus the fair value adjustment.**
- **Equipment = $210,000. Add the two book values.**
- **Total assets = $2,183,000. Summation of the above individual figures.**
- **Accounts payable = $190,000. Add the two book values.**
- **Long-term liabilities = $830,000. Add the two book values plus the debt incurred by the parent in acquiring the subsidiary.**
- **Common stock = $130,000.The parent's book value after stock issue to acquire the subsidiary.**
- **Additional paid-in capital = $528,000.The parent's book value after the stock issue to acquire the subsidiary less the stock issue costs.**

- **Retained earnings = $505,000. Parent company balance less $30,000 in combination expenses plus $115,000 gain on bargain purchase.**
- **Total liabilities and equity = $2,183,000. Summation of the above figures.**

19. ***(continued)***

b. MARSHALL COMPANY AND CONSOLIDATED SUBSIDIARY
Worksheet
January 1, 2011

Accounts	*Marshall Company**	*Tucker Company*	*Consolidation Entries Debit*	*Consolidation Entries Credit*	*Consolidated Totals*
Cash	18,000	20,000			38,000
Receivables	270,000	90,000			360,000
Inventory	360,000	140,000	(A) 5,000		505,000
Land	200,000	180,000	(A) 20,000		400,000
Buildings (net)	420,000	220,000	(A) 30,000		670,000
Equipment (net)	160,000	50,000			210,000
Investment in Tucker	515,000			(S) 460,000	
				(A) 55,000	-0-
Total assets	1,943,000	700,000			2,183,000
Accounts payable	(150,000)	(40,000)			(190,000)
Long-term liabilities	(630,000)	(200,000)			(830,000)
Common stock	(130,000)	(120,000)	(S) 120,000		(130,000)
Additional paid-in capital	(528,000)	-0-			(528,000)
Retained earnings, 1/1/11	(505,000)	(340,000)	(S) 340,000		(505,000)
Total liab. and owners' equity	(1,943,000)	(700,000)			(2,183,000)

Marshall's accounts have been adjusted for acquisition entries (see part a.).

20. (Prepare a consolidated balance sheet)

Consideration transferred at fair value..............		$495,000
Book value		265,000
Excess fair over book value		230,000
Allocation of excess fair value to specific assets and liabilities:		
to computer software....................................	$50,000	
to equipment...	(10,000)	
to client contracts	100,000	
to IPR&D..	40,000	
to notes payable...	(5,000)	175,000
Goodwill		$55,000

	Pratt	Spider	Debit	Credit	Consolidated
Cash	36,000	18,000			54,000
Receivables	116,000	52,000			168,000
Inventory	140,000	90,000			230,000
Investment in Spider	495,000	-0-		(S) 265,000	
				(A) 230,000	-0-
Computer software	210,000	20,000	(A) 50,000		280,000
Buildings (net)	595,000	130,000			725,000
Equipment (net)	308,000	40,000		(A) 10,000	338,000
Client contracts	-0-	-0-	(A) 100,000		100,000
R&D asset	-0-	-0-	(A) 40,000		40,000
Goodwill	-0-	-0-	(A) 55,000		55,000
Total assets	1,900,000	350,000			1,990,000
Accounts payable	(88,000)	(25,000)			(113,000)
Notes payable	(510,000)	(60,000)		(A) 5,000	(575,000)
Common stock	(380,000)	(100,000)	(S)100,000		(380,000)
APIC	(170,000)	(25,000)	(S) 25,000		(170,000)
Retained earnings	(752,000)	(140,000)	(S)140,000		(752,000)
Total liabilities and equities	(1,900,000)	(350,000)	510,000	510,000	(1,990,000)

20. ***(continued)***

Pratt Company and Subsidiary
Consolidated Balance Sheet
December 31, 2011

Assets		***Liabilities and Owners' Equity***	
Cash	**$ 54,000**	**Accounts payable**	**$ (113,000)**
Receivables	**168,000**	**Notes payable**	**(575,000)**
Inventory	**230,000**		
Computer software	**280,000**		
Buildings (net)	**725,000**		
Equipment (net)	**338,000**		
Client contracts	**100,000**	**Common stock**	**(380,000)**
R&D asset	**40,000**	**Additional paid in capital**	**(170,000)**
Goodwill	**55,000**	**Retained earnings**	**(752,000)**
Total assets	**$1,990,000**	**Total liabilities and equities**	**$(1,990,000)**

21. (15 minutes) (Acquisition method entries for a merger)

Case 1:

Fair value of consideration transferred	**$145,000**
Fair value of net identifiable assets	**120,000**
Excess to goodwill	**$25,000**

Case 1 entry on Allerton's books:

Current Assets	**60,000**	
Building	**50,000**	
Land	**20,000**	
Trademark	**30,000**	
Goodwill	**25,000**	
Liabilities		**40,000**
Cash		**145,000**

Case 2: Bargain Purchase under acquisition method

Fair value of consideration transferred	**$110,000**
Fair value of net identifiable assets	**120,000**
Gain on bargain purchase	**$10,000**

Case 2 entry on Allerton's books:

Current Assets	**60,000**	
Building	**50,000**	
Land	**20,000**	
Trademark	**30,000**	
Gain on bargain purchase		**10,000**
Liabilities		**40,000**
Cash		**110,000**

Problem 21. (continued)

In a bargain purchase, the acquisition method employs the fair value of the net identifiable assets acquired as the basis for recording the acquisition. Because this basis exceeds the amount paid, Allerton recognizes a gain on bargain purchase. This is an exception to the general rule of using the fair value of the consideration transferred as the basis for recording the combination.

22. (25 minutes) (Combination entries—acquired entity dissolved)

a. Acquisition Method—Entry to record acquisition of Sampras

Cash consideration transferred	$300,000
Contingent performance obligation	15,000
Consideration transferred (fair value)	315,000
Fair value of net identifiable assets	282,000
Goodwill	$33,000

Receivables	80,000	
Inventory	70,000	
Buildings	115,000	
Equipment	25,000	
Customer list	22,000	
Capitalized R&D	30,000	
Goodwill	33,000	
Current liabilities		10,000
Long-term liabilities		50,000
Contingent performance liability		15,000
Cash		300,000
Combination expenses (legal fees)	10,000	
Cash		10,000

b. Purchase Method—Entry to record acquisition of Sampras

Purchase price	$300,000
Direct combination costs (legal fees)	10,000
Total acquisition cost	$310,000
Fair value of net identifiable assets	282,000
Goodwill	$ 28,000

Receivables	80,000	
Inventory	70,000	
Buildings	115,000	
Equipment	25,000	
Customer list	22,000	
R&D expense	30,000	
Goodwill	28,000	
Current liabilities		10,000

Long-term liabilities	**50,000**
Cash	**310,000**

23. (30 Minutes) (Overview of the steps in applying the acquisition method when shares have been issued to create a combination. Part *h*. includes a bargain purchase.)

a. The fair value of the consideration includes

Fair value of stock issued	**$1,500,000**
Contingent performance obligation	**30,000**
Fair value of consideration transferred	**$1,530,000**

b. Under the acquisition method, stock issue costs reduce additional paid-in capital.

c. The acquisition method records direct costs (such as fees paid to investment banks for arranging the combination) as expenses.

d. The par value of the 20,000 shares issued is recorded as an increase of $20,000 in the Common Stock account. The $74 fair value in excess of par value ($75 – $1) is an increase to additional paid-in capital of $1,480,000 ($74 × 20,000 shares).

e.

Fair value of consideration transferred (above)		**$1,530,000**
Receivables	**$ 80,000**	
Patented technology	**700,000**	
Customer relationships	**500,000**	
IPR&D	**300,000**	
Liabilities	**(400,000)**	**1,180,000**
Goodwill		**$ 350,000**

f. Revenues and expenses of the subsidiary from the period prior to the combination are omitted from the consolidated totals. Only the operational figures for the subsidiary after the purchase are applicable to the business combination. The previous owners earned any previous profits.

g. The subsidiary's Common Stock and Additional Paid-in Capital accounts have no impact on the consolidated totals.

h. The fair value of the consideration transferred is now $1,030,000. This amount indicates a bargain purchase:

Fair value of consideration transferred (above)		**$1,030,000**
Receivables	**$ 80,000**	
Patented technology	**700,000**	
Customer relationships	**500,000**	
IPR&D asset	**300,000**	

Liabilities	(400,000)	1,180,000
Gain on bargain purchase		**$ 150,000**

24. (50 Minutes) (Prepare balance sheet for a statutory merger using the acquisition method. Also, use worksheet to derive consolidated totals.)

a. In accounting for the combination of NewTune and On-the-Go, the fair value of the acquisition is allocated to each identifiable asset and liability acquired with any remaining excess attributed to goodwill.

Fair value of consideration transferred (shares issued)		$750,000
Fair value of net assets acquired:		
Cash	$29,000	
Receivables	63,000	
Trademarks	225,000	
Record music catalog	180,000	
In-process R&D	200,000	
Equipment	105,000	
Accounts payable	(34,000)	
Notes payable	(45,000)	723,000
Goodwill		$27,000

Entry by NewTune to record combination with On-the-Go:

Cash	29,000	
Receivables	63,000	
Trademarks	225,000	
Record Music Catalog	180,000	
Capitalized R&D	200,000	
Equipment	105,000	
Goodwill	27,000	
Accounts Payable		34,000
Notes Payable		45,000
Common Stock (NewTune par value)		60,000
Additional Paid-in Capital		690,000
(To record merger with On-the-Go at fair value)		

Additional Paid-in Capital	25,000	
Cash		25,000
(Stock issue costs incurred)		

Problem 24 (continued):

Post-Combination Balance Sheet:

Assets **Liabilities and Owners' Equity**

Cash	**$ 64,000**	**Accounts payable**	**$ 144,000**
Receivables	**213,000**	**Notes payable**	**415,000**
Trademarks	**625,000**		
Record music catalog	**1,020,000**		
Capitalized R&D	**200,000**	**Common stock**	**460,000**
Equipment	**425,000**	**Additional paid-in capital**	**695,000**
Goodwill	**27,000**	**Retained earnings**	**860,000**
Total	**$ 2,574,000**	**Total**	**$ 2,574,000**

b. Because On-the-Go continues as a separate legal entity, NewTune first records the acquisition as an investment in the shares of On-the-Go.

Investment in On-the-Go Co	**750,000**	
Common Stock (NewTune, Inc., par value)		**60,000**
Additional Paid-in Capital		**690,000**
(To record acquisition of On-the-Go's shares)		

Additional Paid-in Capital	**25,000**	
Cash		**25,000**
(Stock issue costs incurred)		

Next, NewTune’s accounts are adjusted for the entries above to facilitate the worksheet preparation of the consolidated financial statements.

24. (continued)
b.

NEWTUNE, INC., AND ON-THE-GO CO.
Consolidation Worksheet
January 1, 2011

Accounts	*NewTune, Inc.*	*On-the-Go Co.*	*Consolidation Entries* Debit	*Consolidation Entries* Credit	*Consolidated Totals*
Cash	35,000	29,000			64,000
Receivables	150,000	65,000		(A) 2,000	213,000
Investment in On-the-Go	750,000	-0-		(S) 270,000	
				(A) 480,000	-0-
Trademarks	400,000	95,000	(A) 130,000		625,000
Record music catalog	840,000	60,000	(A) 120,000		1,020,000
R&D asset	-0-	-0-	(A) 200,000		200,000
Equipment	320,000	105,000			425,000
Goodwill	-0-	-0-	(A) 27,000		27,000
Totals	2,495,000	354,000			2,574,000
Accounts payable	110,000	34,000			144,000
Notes payable	370,000	50,000	(A) 5,000		415,000
Common stock	460,000	50,000	(S) 50,000		460,000
Additional paid-in capital	695,000	30,000	(S) 30,000		695,000
Retained earnings	860,000	190,000	(S) 190,000		860,000
Totals	2,495,000	354,000			2,574,000

Note: **The accounts of NewTune have already been adjusted for the first three journal entries indicated in the answer to Part b. to record the acquisition fair value and the stock issuance costs.**

The consolidation entries are designed to:

- **Eliminate the stockholders' equity accounts of the subsidiary (S)**
- **Record all subsidiary assets and liabilities at fair value (A)**
- **Recognize the goodwill indicated by the acquisition fair value (A)**
- **Eliminate the Investment in On-the-Go account (S, A)**

c. The consolidated balance sheets in parts a. and b. above are identical. The financial reporting consequences for a 100% stock acquisition vs. a merger are the same. The economic substances of the two forms of the transaction are identical and, therefore, so are the resulting financial statements.

25. (40 minutes) (Prepare a consolidated balance sheet using the acquisition method).

a. Entry to record the acquisition on Pacifica's records.

Investment in Seguros	1,062,500	
Common Stock (50,000 × $5)		250,000
Additional Paid-In Capital (50,000 × $15)		750,000
Contingent performance obligation		62,500

The contingent consideration is computed as:
$130,000 payment × 50% probability × 0.961538 present value factor

Combination expenses	15,000	
Cash		15,000
APIC	9,000	
Cash		9,000

b. and c.

	Pacifica	Seguros	Consolidation Entries		Consolidated Balance Sheet
Revenues	(1,200,000)				(1,200,000)
Expenses	890,000				890,000
Net income	(310,000)				(310,000)
Retained earnings, 1/1	(950,000)				(950,000)
Net income	(310,000)				(310,000)
Dividends paid	90,000				90,000
Retained earnings, 12/31	(1,170,000)				(1,170,000)
Cash	86,000	85,000			171,000
Receivables and inventory	750,000	190,000		(A) 10,000	930,000
Property, plant and equip.	1,400,000	450,000	(A)150,000		2,000,000
Investment in Seguros	1,062,500			(S) 705,000 (A) 357,500	0
R&D asset			(A)100,000		100,000
Goodwill			(A) 77,500		77,500
Trademarks	300,000	160,000	(A) 40,000		500,000
Total assets	3,598,500	885,000			3,778,500
Liabilities	(500,000)	(180,000)			(680,000)
Contingent obligation	(62,500)				(62,500)
Common stock	(650,000)	(200,000)	(S) 200,000		(650,000)

Additional paid-in capital	**(1,216,000)**	**(70,000)**	**(S) 70,000**	**(1,216,000)**
Retained earnings	**(1,170,000)**	**(435,000)**	**(S) 435,000**	**(1,170,000)**
Total liabilities and equities	**(3,598,500)**	**(885,000)**		**(3,778,500)**

Answers to Purchase Method Problems

26. (30 Minutes) (Overview of the steps in applying the purchase method when shares have been issued to create a combination. Includes a bargain purchase.)

a. Purchases are recorded at the fair value exchanged. In this case, 20,000 shares were issued valued at $55 per share. Thus, the purchase price is $1.1 million.

b. The book value equals assets minus liabilities. For Bakel, the assets are ($1,380,000 – $400,000 = $980,000). The same total can be derived from the stockholders' equity accounts after closing out revenues and expenses.

c. Under the purchase method, stock issue costs reduce additional paid-in capital. Direct costs of a combination are added to the purchase price.

d. The par value of the 20,000 shares issued is recorded as an increase of $100,000 in the Common Stock account. The $50 fair value in excess of par value ($55 – $5) is an increase to additional paid-in capital of $1 million ($50 × 20,000 shares).

e.

Cost (above)		**$1,100,000**
Book value (above)		**980,000**
Cost in excess of book value		**$ 120,000**
Allocations to specific accounts based on difference between fair value and book value:		
Inventory	**$ 80,000**	
Land	**(200,000)**	
Building	**100,000**	
Liabilities	**70,000**	**50,000**
Goodwill		**$70,000**

Homewood allocates the $1,100,000 cost as follows:

Receivables $ 80,000

Inventory	**280,000**
Land	**400,000**
Building	**600,000**
Goodwill	**70,000**
Liabilities	**(330,000)**
	$1,100,000

26. ***(continued)***

f. In-process research and development would be recorded at $60,000 and goodwill would be reduced to $10,000. Acquired in-process research and development is typically reported as an expense in the year of the acquisition assuming (1) no alternative use for the assets involved in the research and development, and (2) no resulting products have reached technological feasibility.

g. Revenues and expenses of the subsidiary from the period prior to the combination are omitted from the consolidated totals. Only the operational figures for the subsidiary after the purchase are applicable to the business combination. The previous owners earned any previous profits.

h. The subsidiary's Common Stock and Additional Paid-in Capital accounts have no impact on the consolidated totals.

i. The subsidiary's asset and liability accounts are consolidated at their fair values with any excess payment being attributed to goodwill. The equity, revenue, and expense figures of the subsidiary do not affect the financial reports at the date of acquisition. The parent records the issuance of the 20,000 new shares and the payment of the stock issue costs.

j. If the stock was worth only $40 per share, the purchase price is now $800,000. This amount indicates a bargain purchase:

Purchase price (above)....................................		**$ 800,000**
Book value (above)		**980,000**
Book value in excess of purchase price.		**$(180,000)**
Allocations to specific accounts based on difference between fair value and book value:		
Inventory...	**$ 80,000**	
Land	**(200,000)**	

Building	**100,000**	
Liabilities	**70,000**	**50,000**
Excess fair value over cost		**$(230,000)**

The bargain purchase figure is allocated between the land and building based on their fair values of $400,000 (40%) and $600,000 (60%). Therefore, all of the assets and liabilities are consolidated at fair value except the land is reported at $92,000 below fair value ($230,000 × 40%) and the building is reported at $138,000 below fair value ($230,000 × 60%).

27. (10 Minutes) (Consolidated balances–purchase method)

a. Purchase price (fair value):

Cash	**$1,400,000**	
Stock issued	**800,000**	**$2,200,000**
Book value of assets (no liabilities are indicated)		**2,000,000**
Cost in excess of book value		**200,000**
Excess cost assigned to Buildings account based on fair value		**100,000**
Goodwill		**$100,000**

b. None of Winston's expenses will be included in consolidated figures as of the date of acquisition. Only subsidiary expenses incurred after that date are applicable to the business combination. Under the purchase method, the $30,000 stock issue costs reduce additional paid-in capital.

c. None of Winston's beginning retained earnings balance is included in consolidated figures as of the date of acquisition. As in Part b. (above), only the subsidiary's operational figures recognized after the February 1 purchase relate to the business combination.

d. Buildings should be reported at $1,000,000. Unless a bargain purchase has occurred, assets acquired are recorded at fair value.

28. (10 Minutes) (Consolidated balances–purchase method)

a.

Purchase price: (includes combination costs)	**$2,340,000**
Book value of assets (no liabilities are indicated)	**2,000,000**
Cost in excess of book value	**340,000**
Excess cost assigned to Buildings account based on fair value	**100,000**

Goodwill.. $240,000

b. None of Winston's expenses are included in consolidated figures as of the date of acquisition. Only subsidiary expenses incurred after that date are applicable to the business combination.

c. None of Winston's beginning retained earnings balance are included in consolidated figures as of the date of acquisition. As in Part b. (above), only the subsidiary's operational figures recognized after the February 1, purchase relate to the business combination.

d. Buildings should be reported at $1,000,000. Unless a bargain purchase occurs, assets acquired are recorded at fair value.

29. (20 Minutes) (Consolidated balances for a bargain purchase–*purchase method*)

a. Inventory (fair value) $600,000

b. A bargain purchase has occurred; thus, no goodwill is recognized.

Purchase price (includes direct combination costs)	**$2,040,000**
Book value of assets (no liabilities are indicated)	**2,000,000**
Cost in excess of book value	**40,000**
Excess cost assigned to Buildings account based on fair value	**100,000**
Bargain purchase	**$(60,000)**

Allocation of $60,000 Bargain Purchase:

Noncurrent Assets	***Fair Value***	***Percentage***	***Allocation***
Land	**$500,000**	**33⅓%**	**$(20,000)**
Buildings	**1,000,000**	**66⅔%**	**(40,000)**
Totals	**$1,500,000**	**100%**	**$(60,000)**

c. None of Winston's expenses are reported in consolidated figures as of the date of acquisition. Only subsidiary expenses incurred after that date are included by the combined firm.

d. Buildings at fair value....................................... $1,000,000
Bargain purchase reduction (see b. above)..... (40,000)

Balance to be consolidated	$960,000

e.	Land at fair value...	$500,000
	Bargain purchase reduction (see b. above).....	(20,000)
	Balance to be consolidated	$480,000

30. (45 Minutes) (Purchase Method--Prepare entries for a statutory merger. Also, use worksheet to derive consolidated totals.)

a. In accounting for the combination of Merrill, Inc. and Harriss Co., the total cost of the acquisition is first determined and then allocated to each identifiable asset and liability acquired with any remaining excess attributed to goodwill.

30. a. *(continued)*

Cash paid	$200,000
Fair value of shares issued	180,000
Direct acquisition costs	10,000
Cost of acquisition	$390,000

Cost of acquisition (above)		$390,000
Fair value of net assets acquired:		
Cash	$40,000	
Receivables	80,000	
Inventory	130,000	
Land	60,000	
Buildings	140,000	
Equipment	50,000	
Patent	30,000	
Accounts Payable	(30,000)	
Long-Term Liabilities	(150,000)	350,000
Goodwill		$40,000

Entry by Merrill to record assets acquired and liabilities assumed in the combination with Harriss:

Cash	40,000
Receivables	80,000
Inventory	130,000
Land	60,000
Buildings	140,000
Equipment	50,000
Patent	30,000

Goodwill	**40,000**	
Accounts Payable		**30,000**
Long-Term Liabilities		**150,000**
Cash		**210,000**
Common Stock (Merrill, Inc., par value)		**100,000**
Additional Paid-in Capital		**80,000**
(To record merger with Harriss at cost)		

Additional Paid-in Capital	**6,000**	
Cash		**6,000**
(Stock issue costs incurred)		

30. ***(continued)***

b. Because Harriss continues as a separate legal entity, Merrill first records the acquisition as an investment in the shares of Harriss.

Investment in Harriss Co	**380,000**	
Cash		**200,000**
Common Stock (Merrill, Inc., par value)		**100,000**
Additional Paid-in Capital		**80,000**
(To record purchase of Harriss' shares)		

Investment in Harriss Co.	**10,000**	
Cash		**10,000**
(Direct combination costs incurred)		

Additional Paid-in Capital	**6,000**	
Cash		**6,000**
(Stock issue costs incurred)		

Next, Merrill's accounts are adjusted for the entries above to facilitate the worksheet preparation of the consolidated financial statements.

30. (continued)

b.

MERRILL, INC., AND HARRISS CO.
Consolidation Worksheet
January 1, 2008

Accounts	*Merrill, Inc.*	*Harriss Co.*	*Consolidation Entries Debit*	*Consolidation Entries Credit*	*Consolidated Totals*
Debits					
Cash	84,000	40,000			124,000
Receivables	160,000	90,000		(A) 10,000	240,000
Inventory	220,000	130,000			350,000
Investment in Harriss	390,000	-0-		(S) 280,000	
				(A) 110,000	-0-
Land	100,000	60,000			160,000
Buildings	400,000	110,000	(A) 30,000		540,000
Equipment	120,000	50,000			170,000
Patent	-0-	-0-	(A) 30,000		30,000
Goodwill	-0-	-0-	(A) 40,000		40,000
Totals	1,474,000	480,000			1,654,000
Credits					
Accounts payable	160,000	30,000			190,000
Long-term liabilities	380,000	170,000	(A) 20,000		530,000
Common stock	500,000	40,000	(S) 40,000		500,000
Additional paid-in capital	74,000	-0-			74,000
Retained earnings	360,000	240,000	(S) 240,000		360,000
Totals	1,474,000	480,000			1,654,000

Note: **The accounts of Merrill have already been adjusted for the first three journal entries indicated in the answer to Part b. to record the purchase price, the direct acquisition costs, and the stock issuance costs.**

The consolidation entries are designed to:

- **Eliminate the stockholders' equity accounts of the subsidiary**
- **Record all subsidiary assets and liabilities at fair value (including the patent)**
- **Recognize the goodwill indicated by the acquisition price**
- **Eliminate the Investment in Harriss account**

Answers to Pooling Method Problems

31. B

32. (20 Minutes) (Asks for verbal discussion of the pooling of interests method)

a. In a pooling of interests, the book values of all assets and liabilities of the two separate companies were simply added for the combined corporation. A business combination that is accounted for as a pooling of interests was a combination of the ownership interests of two previously separated companies. Because the ownership technically did not change, no event occurred mandating a change in recorded values. The existing basis of accounting continued for both companies.

b. For a pooling of interests, the registration fees and any other direct costs relating to the business combination were considered period expenses of the resulting combined corporation.

c. Although the companies combined during the year, in a pooling of interests, the combination was reported as if the companies had always been combined. Revenues for both companies for the entire year were reported as well as expenses. Operations were combined retroactively.

33. (25 minutes) (Pooling vs. purchase involving an unrecorded intangible)

a.

	Purchase	Pooling
Inventory	$ 650,000	$ 600,000
Land	750,000	450,000
Buildings	1,000,000	900,000
Unpatented technology	1,500,000	-0-
Goodwill	600,000	-0-
Total	$4,500,000	$1,950,000

b. Pre-acquisition revenues and expenses were excluded from consolidated results under the purchase method, but were included under the pooling method.

c. Poolings, in most cases, produce higher rates of return on assets than purchase accounting because the denominator typically is much lower. In the case of the Swimwear acquisition pooling produced an increment to total assets of $1,950,000 compared to $4,500,000 under purchase accounting. Future EPS under poolings were also higher because of lower future depreciation and amortization of the smaller asset base.

Managers whose compensation contracts involved accounting performance measures clearly had incentives to use pooling of interest accounting whenever possible.

Chapter 2 Develop Your Skills

CONSIDERATION OR COMPENSATION CASE (estimated time 40 minutes)

According to FASB ASC (805-10-55-25):

If it is not clear whether an arrangement for payments to employees or selling shareholders is part of the exchange for the acquiree or is a transaction separate from the business combination, the acquirer should consider the following indicators:

a. **Continuing employment. The terms of continuing employment by the selling shareholders who become key employees may be an indicator of the substance of a contingent consideration arrangement. The relevant terms of continuing employment may be included in an employment agreement, acquisition agreement, or some other document. A contingent consideration arrangement in which the payments are automatically forfeited if employment terminates is compensation for postcombination services. Arrangements in which the contingent payments are not affected by employment termination may indicate that the contingent payments are additional consideration rather than compensation.**
b. **Duration of continuing employment. If the period of required employment coincides with or is longer than the contingent payment period, that fact may indicate that the contingent payments are, in substance, compensation.**
c. **Level of compensation. Situations in which employee compensation other than the contingent payments is at a reasonable level in comparison to that of other key employees in the combined entity may indicate that the contingent payments are additional consideration rather than compensation.**
d. **Incremental payments to employees. If selling shareholders who do not become employees receive lower contingent payments on a per-share basis than the selling shareholders who become employees of the combined entity, that fact may indicate that the incremental amount of contingent payments to the selling shareholders who become employees is compensation.**
e. **Number of shares owned. The relative number of shares owned by the selling shareholders who remain as key employees may be an indicator of the substance of the contingent consideration arrangement. For example, if the selling shareholders who owned substantially all of the shares in the acquiree continue as key employees, that fact may indicate that the arrangement is, in substance, a profit-sharing arrangement intended to provide compensation for postcombination services. Alternatively, if selling shareholders who continue as key employees owned only a small number of shares of the acquiree and all selling shareholders receive the same amount of contingent consideration on a per-share basis, that fact may indicate that the contingent payments are additional consideration. The preacquisition ownership interests held by parties related to selling shareholders who continue as key employees, such as family members, also should be considered.**
f. **Linkage to the valuation. If the initial consideration transferred at the acquisition date is based on the low end of a range established in the valuation of the**

acquiree and the contingent formula relates to that valuation approach, that fact may suggest that the contingent payments are additional consideration. Alternatively, if the contingent payment formula is consistent with prior profit-sharing arrangements, that fact may suggest that the substance of the arrangement is to provide compensation.

g. Formula for determining consideration. The formula used to determine the contingent payment may be helpful in assessing the substance of the arrangement. For example, if a contingent payment is determined on the basis of a multiple of earnings, that might suggest that the obligation is contingent consideration in the business combination and that the formula is intended to establish or verify the fair value of the acquiree. In contrast, a contingent payment that is a specified percentage of earnings might suggest that the obligation to employees is a profit-sharing arrangement to compensate employees for services rendered.

Suggested answer:

Note: This case was designed to have conflicting indicators across the various criteria identified in the FASB ASC for determining the issue of compensation vs. consideration. Thus, the solution is subject to alternative explanations and student can be encouraged to use their own judgment and interpretations in supporting their answers.

In the author's judgment, the $8 million contingent payment (fair value = $4 million) is contingent consideration to be included in the overall fair value NaviNow records for its acquisition of TrafficEye. This contingency is not dependent on continuing employment (criteria a.), and uses a formula based on a component of earnings (criteria g.). Even though the four former owners of TrafficEye owned 100% of the shares (criteria e.), which suggests the $8 million is compensation, the overall fact pattern indicates consideration because no services are required for the payment.

The profit-sharing component of the employment contract appears to be compensation. Criteria g. specifically identifies profit-sharing arrangements as indicative of compensation for services rendered. Criteria a. also applies given that the employees would be unable to participate in profit-sharing if they terminate employment. Although the employees receive non-profit sharing compensation similar to other employees (criteria c.), the overall pattern of evidence suggests that any payments made under the profit-sharing arrangement should be recognized as compensation expense when incurred and not contingent consideration for the acquisition.

RESEARCH CASE—ABBOTT'S ACQUISITION OF ADVANCED MEDICAL OPTICS

(20-25 Minutes)

1. Abbott accounted for its February 25, 2009 acquisition of Advanced Medical Optics using the acquisition method. Accordingly Abbott recorded the acquisition at $1.4 billion.

2. From Abbott's 3/31/09 10-Q report (dollars in millions)

		As of February 25, 2009
Total fair value		$1.4
Acquired intangible assets, non-deductible	0.9	
Acquired in-process research and development	0.2	

Acquired net tangible assets	**0.5**	
Acquired debt	**(1.5)**	
Deferred income taxes recorded at acquisition	**(0.3)**	
Total net fair value of net identifiable assets		**(.20)**
Goodwill		**$ 1.60**

Abbott determined these allocations by estimating fair values for each of the assets acquired and the liabilities assumed.

3. Acquired in-process research and development will be accounted for as an indefinite lived intangible asset until regulatory approval or discontinuation.

4. Abbott incurred approximately $55 million of acquisition related expenses which are classified as Selling, general and administrative expense.

5. The motivation for the acquisition is referred to in the 10-Q report as follows: Abbott acquired AMO to take advantage of increasing demand for vision care technologies due to population growth and demographic shifts and AMO's premier position in its field.

FASB Codification Research Case: The Dow Chemical Company's Acquired Contingencies (Estimated Time: 1hour)

1. **Did Dow Chemical recognize any acquired contingencies for its acquisition of Rohm and Haas? If it did, how were they measured? If not, why not?**

   Solution: Dow Chemical recognized certain contingent environmental liabilities of $159 million and a liability of $185 million related to Rohm and Haas Pension Plan matters, which were valued in accordance with SFAS No. 5, "Accounting for Contingencies."

2. **Under what circumstances should a firm recognize an asset acquired or a liability assumed in a business combination that arises from a contingency?**

   Solution: According to FASB ASC, an asset acquired or a liability assumed in a business combination that arises from a contingency needs to be recognized if the acquisition-date fair value is determinable or if the contingency is both probable and estimable at the acquisition date.

   Dow Chemical Case continued:

   FASB ASC:

   > **An acquirer shall recognize at fair value, at the acquisition date, an asset acquired or a liability assumed in a business combination that arises from a contingency if the acquisition-date fair value of that asset or liability can be determined during the measurement period. FASB ASC 805-20-25-19, 805-20-30-9.**
   >
   > **If the acquisition-date fair value of an asset acquired or a liability assumed in a business combination that arises from a contingency cannot be determined during the measurement period, an asset or a liability shall be recognized at the acquisition date if both of the following criteria are met:**

a. **Information available before the end of the measurement period indicates that it is probable that an asset existed or that a liability had been incurred at the acquisition date.**

b. **The amount of the asset or liability can be reasonably estimated.**

(FASB ASC 805-20-25-20, 805-20-30-23, 805-20-25-20A)

If neither the criterion in paragraph 7 nor the criteria in paragraph 8 are met at the acquisition date using information that is available during the measurement period about facts and circumstances that existed as of the acquisition date, the acquirer shall not recognize an asset or liability as of the acquisition date…. (FASB ASC 805-20-25-20B)

3. **How should Dow Chemical account for its acquired contingencies in periods after the acquisition date?**

   Solution: In periods after the acquisition date, Dow Chemical should develop a systematic and rational basis for subsequently measuring and accounting for these contingencies.

   An acquirer shall develop a systematic and rational basis for subsequently measuring and accounting for assets and liabilities arising from contingencies depending on their nature. (FASB ASC 805-20-35-3)

4. **What is the disclosure requirement for Dow Chemical's acquired contingencies?**

   Solution: Dow Chemical should disclose the amounts recognized at the acquisition date and the measurement basis applied, and also the nature of the contingencies.

   An acquirer shall disclose information that enables users of its financial statements to evaluate the nature and financial effects of a business combination that occurs either during the current reporting period or after the reporting period but before the financial statements are issued.

   For each business combination that occurs during the reporting period, an acquirer shall disclose the following in the footnote that describes the business combination:

   For assets and liabilities arising from contingencies recognized at the acquisition date:

   (1) The amounts recognized at the acquisition date and the measurement basis applied—usually fair value.

   (2) The nature of the contingencies. An acquirer may aggregate disclosures for assets or liabilities arising from contingencies that are similar in nature.

   (FASB ASC 805-20-50-1)

5. **What are some of the concerns with financial reporting standards for acquired contingencies?**

   Solution: There is concern that these standards may not be operational:
   The FASB ASC does not provide guidance on how to make the determination assessment of the acquisition date fair value of an asset acquired or a liability assumed in a business combination that arises from a contingency.

In addition, this standard does not prescribe in detail how an asset or a liability arising from a contingency initially recognized at fair value in a business combination would be measured subsequent to its initial recognition. (Ideas extracted from FSP FAS 141(R)-1 dissent by Tom Linsmeier).