# SOLUTIONS MANUAL

4th EDITION

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# CHAPTER 2

Note: The letter A indicated for a question, exercise, or problem means that the question, exercise, or problem relates to a chapter appendix.

**ANSWERS TO QUESTIONS**

1. At the acquisition date, the information available (and through the end of the measurement period) is used to estimate the expected total consideration at fair value. If the subsequent stock issue valuation differs from this assessment, the *Exposure Draft (SFAS 1204-001)* expected to replace *FASB Statement No. 141R* specifies that equity should not be adjusted. The reason is that the valuation was determined at the date of the exchange, and thus the impact on the firm's equity was measured at that point based on the best information available then.

2. Pro forma financial statements (sometimes referred to as "as if" statements) are financial statements that are prepared to show the effect of planned or contemplated transactions.

3. For purposes of the goodwill impairment test, all goodwill must be assigned to a reporting unit. Goodwill impairment for each reporting unit should be tested in a two-step process. In the first step, the fair value of a reporting unit is compared to its carrying amount (goodwill included) at the date of the periodic review. The fair value of the unit may be based on quoted market prices, prices of comparable businesses, or a present value or other valuation technique. If the fair value at the review date is less than the carrying amount, then the second step is necessary. In the second step, the carrying value of the goodwill is compared to its implied fair value. (The calculation of the implied fair value of goodwill used in the impairment test is similar to the method illustrated throughout this chapter for valuing the goodwill at the date of the combination.)

4. The expected increase was due to the elimination of goodwill amortization expense. However, the impairment loss under the new rules was potentially larger than a periodic amortization charge, and this is in fact what materialized within the first year after adoption (a large impairment loss). If there was any initial stock price impact from elimination of goodwill amortization, it was only a short-term or momentum effect. Another issue is how the stock market responds to the goodwill impairment charge. Some users claim that this charge is a non-cash charge and should be disregarded by the market. However, others argue that the charge is an admission that the price paid was too high, and might result in a stock price decline (unless the market had already adjusted for this overpayment prior to the actual writedown).

## ANSWERS TO BUSINESS ETHICS CASE

a and b. The board has responsibility to look into anything that might suggest malfeasance or inappropriate conduct. Such incidents might suggest broader problems with integrity, honesty, and judgment. In other words, can you trust any reports from the CEO? If the CEO is not fired, does this send a message to other employees that ethical lapses are okay? Employees might feel that top executives are treated differently.

## ANSWERS TO EXERCISES

### Exercise 2-1

| | | Debit | Credit |
|---|---|---|---|
| **Part A** | Receivables | 228,000 | |
| | Inventory | 396,000 | |
| | Plant and Equipment | 540,000 | |
| | Land | 660,000 | |
| | Goodwill ($2,154,000 - $1,824,000) | 330,000 | |
| | Liabilities | | 594,000 |
| | Cash | | 1,560,000 |
| **Part B** | Receivables | 228,000 | |
| | Inventory | 396,000 | |
| | Plant and Equipment | 540,000 | |
| | Land | 660,000 | |
| | Liabilities | | 594,000 |
| | Cash | | 990,000 |
| | Gain on Business Combination ($1,230,000 - $990,000) | | 240,000 |

**Exercise 2-2**

| | |
|---|---|
| Cash | $680,000 |
| Receivables | 720,000 |
| Inventories | 2,240,000 |
| Plant and Equipment (net) ($3,840,000 + $720,000) | 4,560,000 |
| Goodwill | 120,000 |
| Total Assets | $8,320,000 |
| | |
| Liabilities | 1,520,000 |
| Common Stock, $16 par ($3,440,000 + (.50 × $800,000)) | 3,840,000 |
| Other Contributed Capital ($400,000 + $800,000) | 1,200,000 |
| Retained Earnings | 1,760,000 |
| Total Equities | $8,320,000 |

Entries on Petrello Company's books would be:

| | | |
|---|---|---|
| Cash | 200,000 | |
| Receivables | 240,000 | |
| Inventory | 240,000 | |
| Plant and Equipment | 720,000 | |
| Goodwill * | 120,000 | |
| Liabilities | | 320,000 |
| Common Stock (25,000 × $16) | | 400,000 |
| Other Contributed Capital ($48 - $16) × 25,000 | | 800,000 |

* ($48 × 25,000) – [($1,480,000 – ($800,000 – $720,000) – $320,000]
= $1,200,000 – [$1,480,000 – $80,000 – $320,000] = $1,200,000 – $1,080,000 = $120,000

**Exercise 2-3**

| Account | Debit | Credit |
|---|---|---|
| Accounts Receivable | 231,000 | |
| Inventory | 330,000 | |
| Land | 550,000 | |
| Buildings and Equipment | 1,144,000 | |
| Goodwill | 848,000 | |
| Allowance for Uncollectible Accounts ($231,000 - $198,000) | | 33,000 |
| Current Liabilities | | 275,000 |
| Bonds Payable | | 450,000 |
| Premium on Bonds Payable ($495,000 - $450,000) | | 45,000 |
| Preferred Stock (15,000 × $100) | | 1,500,000 |
| Common Stock (30,000 × $10) | | 300,000 |
| Other Contributed Capital ($25 - $10) × 30,000 | | 450,000 |
| Cash | | 50,000 |

| | |
|---|---|
| Cost paid ($1,500,000 + $750,000 + $50,000) = | $2,300,000 |
| Fair value of net assets (198,000 + 330,000 + 550,000 + 1,144,000 – 275,000 – 495,000) = | 1,452,000 |
| Goodwill = | $848,000 |

**Exercise 2-4**

| Account | Debit | Credit |
|---|---|---|
| Cash | 96,000 | |
| Receivables | 55,200 | |
| Inventory | 126,000 | |
| Land | 198,000 | |
| Plant and Equipment | 466,800 | |
| Goodwill* | 137,450 | |
| Accounts Payable | | 44,400 |
| Bonds Payable | | 480,000 |
| Premium on Bonds Payable** | | 45,050 |
| Cash | | 510,000 |

| | | |
|---|---|---|
| ** Present value of maturity value, 12 periods @ 4%: | 0.6246 × $480,000 = | $299,808 |
| Present value of interest annuity, 12 periods @ 4%: | 9.38507 × $24,000 = | 225,242 |
| Total present value | | 525,050 |
| Par value | | 480,000 |
| Premium on bonds payable | | $ 45,050 |

| | | |
|---|---|---|
| *Cash paid | | $510,000 |
| Less: Book value of net assets acquired ($897,600 – $44,400 – $480,000) | | (373,200) |
| Excess of cash paid over book value | | 136,800 |
| Increase in inventory to fair value | (15,600) | |
| Increase in land to fair value | (28,800) | |
| Increase in bond to fair value | 45,050 | |
| Total increase in net assets to fair value | | 650 |
| Goodwill | | $137,450 |

**Exercise 2-5**

| | | |
|---|---|---|
| Current Assets | 960,000 | |
| Plant and Equipment | 1,440,000 | |
| Goodwill | 336,000 | |
| Liabilities | | 216,000 |
| Cash | | 2,160,000 |
| Liability for Contingent Consideration | | 360,000 |

**Exercise 2-6**

The amount of the contingency is $500,000 (10,000 shares at $50 per share)

| | | | |
|---|---|---|---|
| **Part A** | Goodwill | 500,000 | |
| | Paid-in-Capital for Contingent Consideration | | 500,000 |
| **Part B** | Paid-in-Capital for Contingent Consideration | 500,000 | |
| | Common Stock ($10 par) | | 100,000 |
| | Paid-In-Capital in Excess of Par | | 400,000 |

Platz Company does not adjust the original amount recorded as equity.

**Exercise 2-7**

| | | |
|---|---|---|
| 1. (c) | Cost (8,000 shares @ $30) | $240,000 |
| | Fair value of net assets acquired | 228,800 |
| | Excess of cost over fair value (goodwill) | $ 11,200 |
| 2. (c) | Cost (8,000 shares @ $30) | $240,000 |
| | Fair value of net assets acquired ($90,000 + $242,000 – $56,000) | 276,000 |
| | Excess of fair value over cost (gain) | $ 36,000 |

**Exercise 2-8**

| | | |
|---|---|---|
| Current Assets | 362,000 | |
| Long-term Assets ($1,890,000 + $20,000) + ($98,000 + $5,000) | 2,013,000 | |
| Goodwill * | 395,000 | |
| Liabilities | | 119,000 |
| Long-term Debt | | 491,000 |
| Common Stock (144,000 × $5) | | 720,000 |
| Other Contributed Capital (144,000 × ($15 - $5)) | | 1,440,000 |

* (144,000 $\times$ \$15) – [\$362,000 + \$2,013,000 – (\$119,000 + \$491,000)] = \$395,000

Total shares issued $\left(\frac{\$700{,}000}{\$5} + \frac{\$20{,}000}{\$5}\right)$ = 144,000

Fair value of stock issued (144,000 $\times$ \$15) = \$2,160,000

**Exercise 2-9**

**Case A**

| | |
|---|---|
| Cost (Purchase Price) | \$130,000 |
| Less: Fair Value of Net Assets | 120,000 |
| Goodwill | \$ 10,000 |

**Case B**

| | |
|---|---|
| Cost (Purchase Price) | \$110,000 |
| Less: Fair Value of Net Assets | 90,000 |
| Goodwill | \$ 20,000 |

**Case C**

| | |
|---|---|
| Cost (Purchase Price) | \$15,000 |
| Less: Fair Value of Net Assets | 20,000 |
| Gain | (\$ 5,000) |

| | Assets | | | Liabilities | Retained Earnings (Gain) |
|---|---|---|---|---|---|
| | Goodwill | Current Assets | Long-Lived Assets | | |
| Case A | \$10,000 | \$20,000 | \$130,000 | \$30,000 | 0 |
| Case B | 20,000 | 30,000 | 80,000 | 20,000 | 0 |
| Case C | 0 | 20,000 | 40,000 | 40,000 | 5,000 |

**Exercise 2-10**

**Part A.**

| 2011: | **Step 1**: Fair value of the reporting unit | | $400,000 |
|---|---|---|---|
| | Carrying value of unit: | | |
| | Carrying value of identifiable net assets | $330,000 | |
| | Carrying value of goodwill ($450,000 - $375,000) | 75,000 | |
| | | | 405,000 |
| | Excess of carrying value over fair value | | $ 5,000 |

The excess of carrying value over fair value means that step 2 is required.

| **Step 2:** Fair value of the reporting unit | $400,000 |
|---|---|
| Fair value of identifiable net assets | 340,000 |
| Implied value of goodwill | 60,000 |
| Recorded value of goodwill ($450,000 - $375,000) | 75,000 |
| Impairment loss | $ 15,000 |

| 2012: | **Step 1**: Fair value of the reporting unit | | $400,000 |
|---|---|---|---|
| | Carrying value of unit: | | |
| | Carrying value of identifiable net assets | $320,000 | |
| | Carrying value of goodwill ($75,000 - $15,000) | 60,000 | |
| | | | 380,000 |
| | Excess of fair value over carrying value | | $ 20,000 |

The excess of fair value over carrying value means that step 2 is **not** required.

| 2013: | **Step 1**: Fair value of the reporting unit | | $350,000 |
|---|---|---|---|
| | Carrying value of unit: | | |
| | Carrying value of identifiable net assets | $300,000 | |
| | Carrying value of goodwill ($75,000 - $15,000) | 60,000 | |
| | | | 360,000 |
| | Excess of carrying value over fair value | | $ 10,000 |

The excess of carrying value over fair value means that step 2 is required.

| **Step 2**: Fair value of the reporting unit | $350,000 |
|---|---|
| Fair value of identifiable net assets | 325,000 |
| Implied value of goodwill | 25,000 |
| Recorded value of goodwill ($75,000 - $15,000) | 60,000 |
| Impairment loss | $ 35,000 |

**Part B.**

| | | | |
|---|---|---|---|
| 2011: | Impairment Loss—Goodwill | 15,000 | |
| | Goodwill | | 15,000 |
| 2012: | No entry | | |
| 2013: | Impairment Loss—Goodwill | 35,000 | |
| | Goodwill | | 35,000 |

**Part C.**

*SFAS No. 142* specifies the presentation of goodwill in the balance sheet and income statement (if impairment occurs) as follows:

- The aggregate amount of goodwill should be a separate line item in the balance sheet.
- The aggregate amount of losses from goodwill impairment should be shown as a separate line item in the operating section of the income statement unless some of the impairment is associated with a discontinued operation (in which case it is shown net-of-tax in the discontinued operation section).

**Part D.**

In a period in which an impairment loss occurs, *SFAS No. 142* mandates the following disclosures in the notes:

(1) A description of the facts and circumstances leading to the impairment;
(2) The amount of the impairment loss and the method of determining the fair value of the reporting unit;
(3) The nature and amounts of any adjustments made to impairment estimates from earlier periods, if significant.

**Exercise 2-11**

a. Fair Value of Identifiable Net Assets

| | |
|---|---|
| Book values $500,000 – $100,000 = | $400,000 |
| Write up of Inventory and Equipment: | |
| ($20,000 + $30,000) = | 50,000 |
| Purchase price above which goodwill would result | $450,000 |

b. Equipment would not be written down, regardless of the purchase price, unless it was reviewed and determined to be overvalued originally.
c. A gain would be shown if the purchase price was below $450,000.
d. Anything below $450,000 is technically considered a bargain.
e. Goodwill would be $50,000 at a purchase price of $500,000 or ($450,000 + $50,000).

**Exercise 2-12A**

| | | |
|---|---|---|
| Cash | 20,000 | |
| Accounts Receivable | 112,000 | |
| Inventory | 134,000 | |
| Land | 55,000 | |
| Plant Assets | 463,000 | |
| Discount on Bonds Payable | 20,000 | |
| Goodwill* | 127,200 | |
| Allowance for Uncollectible Accounts | | 10,000 |
| Accounts Payable | | 54,000 |
| Bonds Payable | | 200,000 |
| Deferred Income Tax Liability | | 67,200 |
| Cash | | 600,000 |

| | |
|---|---|
| Cost of acquisition | $600,000 |
| Book value of net assets acquired ($80,000 + $132,000 + $160,000) | 372,000 |
| Difference between cost and book value | 228,000 |
| Allocated to: | |
| Increase inventory, land, and plant assets to fair value ($52,000 + $25,000 + $71,000) | (148,000) |
| Decrease bonds payable to fair value | (20,000) |
| Establish deferred income tax liability ($168,000 × 40%) | 67,200 |
| Balance assigned to goodwill | $127,200 |

**ANSWERS TO PROBLEMS**

**Problem 2-1**

| | | |
|---|---|---|
| Current Assets | 85,000 | |
| Plant and Equipment | 150,000 | |
| Goodwill* | 100,000 | |
| Liabilities | | 35,000 |
| Common Stock [(20,000 shares @ $10/share)] | | 200,000 |
| Other Contributed Capital [(20,000 × ($15 – $10))] | | 100,000 |

| | | |
|---|---|---|
| Acquisition Costs Expense | 20,000 | |
| Cash | | 20,000 |
| | | |
| Other Contributed Capital | 6,000 | |
| Cash | | 6,000 |
| To record the direct acquisition costs and stock issue costs | | |

* Goodwill = Excess of Consideration of $335,000 (stock valued at $300,000 plus debt assumed of $35,000) over Fair Value of Identifiable Assets of $235,000 (total assets of $225,000 plus PPE fair value adjustment of $10,000)

**Problem 2-2**

Acme Company
Balance Sheet
October 1, 2011
(000)

**Part A.**

| | | |
|---|---|---|
| Assets (except goodwill) (\$3,900 + \$9,000 + \$1,300) | | \$14,200 |
| Goodwill (1) | | 1,160 |
| Total Assets | | \$15,360 |
| | | |
| Liabilities (\$2,030 + \$2,200 + \$260) | | \$4,490 |
| Common Stock (180 × \$20) + \$2,000 | | 5,600 |
| Other Contributed Capital (180 × (\$50 – \$20)) | | 5,400 |
| Retained Earnings | | (130) |
| Total Liabilities and Equity | | \$15,360 |
| | | |
| (1) Cost (180 × \$50) | | \$9,000 |
| Fair value of net assets acquired: | | |
| Fair value of assets of Baltic and Colt | \$10,300 | |
| Less liabilities assumed | 2,460 | 7,840 |
| Goodwill | | \$1,160 |

**Problem 2-2 (continued)**

**Part B.**

**Baltic**

| | | | |
|---|---|---|---|
| 2012: **Step1**: Fair value of the reporting unit | | | $6,500,000 |
| Carrying value of unit: | | | |
| Carrying value of identifiable net assets | 6,340,000 | | |
| Carrying value of goodwill | 200,000* | | |
| Total carrying value | | 6,540,000 | |

*[(140,000 x $50) – ($9,000,000 – $2,200,000)]

The excess of carrying value over fair value means that step 2 is required.

| | |
|---|---|
| **Step 2:** Fair value of the reporting unit | $6,500,000 |
| Fair value of identifiable net assets | 6,350,000 |
| Implied value of goodwill | 150,000 |
| Recorded value of goodwill | 200,000 |
| Impairment loss | $ 50,000 |

(because $150,000 < $200,000)

**Colt**

| | | | |
|---|---|---|---|
| 2012: **Step1**: Fair value of the reporting unit | | | $1,900,000 |
| Carrying value of unit: | | | |
| Carrying value of identifiable net assets | $1,200,000 | | |
| Carrying value of goodwill | 960,000* | | |
| Total carrying value | | 2,160,000 | |

*[(40,000 x $50) – ($1,300,000 – $260,000)]

The excess of carrying value over fair value means that step 2 is required.

| | |
|---|---|
| **Step 2:** Fair value of the reporting unit | $1,900,000 |
| Fair value of identifiable net assets | 1,000,000 |
| Implied value of goodwill | 900,000 |
| Recorded value of goodwill | 960,000 |
| Impairment loss | $ 60,000 |

(because $900,000 < $960,000)

Total impairment loss is $110,000.

Journal entry:

| | | |
|---|---|---|
| Impairment Loss | $110,000 | |
| Goodwill | | $110,000 |

**Problem 2-3**

| | | |
|---|---|---|
| Present value of maturity value, 20 periods @ 6%: | 0.3118 × $600,000 = | $187,080 |
| Present value of interest annuity, 20 periods @ 6%: | 11.46992 × $30,000 = | 344,098 |
| Total Present value | | 531,178 |
| Par value | | 600,000 |
| Discount on bonds payable | | $68,822 |

| | Debit | Credit |
|---|---|---|
| Cash | 114,000 | |
| Accounts Receivable | 135,000 | |
| Inventory | 310,000 | |
| Land | 315,000 | |
| Buildings | 54,900 | |
| Equipment | 39,450 | |
| Bond Discount ($40,000 + $68,822) | 108,822 | |
| Current Liabilities | | 95,300 |
| Bonds Payable ($300,000 + $600,000) | | 900,000 |
| Gain on Purchase of Business | | 81,872 |

Computation of Excess of Net Assets Received Over Cost

| | |
|---|---|
| Cost (Purchase Price) ($531,178 plus liabilities assumed of $95,300 and $260,000) | $886,478 |
| Less: Total fair value of assets received | $968,350 |
| Excess of fair value of net assets over cost | ($ 81,872) |

**Problem 2-4**

**Part A** January 1, 2011

| | Debit | Credit |
|---|---|---|
| Accounts Receivable | 72,000 | |
| Inventory | 99,000 | |
| Land | 162,000 | |
| Buildings | 450,000 | |
| Equipment | 288,000 | |
| Goodwill* | 54,000 | |
| Allowance for Uncollectible Accounts | | 7,000 |
| Accounts Payable | | 83,000 |
| Note Payable | | 180,000 |
| Cash | | 720,000 |
| Liability for Contingent Consideration | | 135,000 |

*Computation of Goodwill

| | |
|---|---|
| Cash paid ($720,000 + $135,000) | $855,000 |
| Total fair value of net assets acquired ($1,064,000 - $263,000) | 801,000 |
| Goodwill | $ 54,000 |

**Problem 2-4 (continued)**

**Part B** January 2, 2013

| | Debit | Credit |
|---|---|---|
| Liability for Contingent Consideration | 135,000 | |
| Cash | | 135,000 |

**Part C** January 2, 2013

| | Debit | Credit |
|---|---|---|
| Liability for Contingent Consideration | 135,000 | |
| Income from Change in Estimate | | 135,000 |

**Problem 2-5**

Pepper Company
Pro Forma Balance Sheet
Giving Effect to Proposed Issue of Common Stock and Note Payable for
All of the Common Stock of Salt Company under Purchase Accounting
December 31, 2010

| | Audited Balance Sheet | Adjustments | Pro Forma Balance Sheet |
|---|---|---|---|
| Cash | $180,000 | 405,000 | $585,000 |
| Receivables | 230,000 | (60,000) | 287,000 |
| | | 117,000 | |
| Inventories | 231,400 | 134,000 | 365,400 |
| Plant Assets | 1,236,500 | 905,000 (1) | 2,141,500 |
| Goodwill | | 181,500 | 181,500 |
| Total Assets | $1,877,900 | | $3,560,400 |
| | | | |
| Accounts Payable | $255,900 | (60,000) | $375,900 |
| | | 180,000 | |
| Notes Payable, 8% | 0 | 300,000 | 300,000 |
| Mortgage Payable | 180,000 | 152,500 | 332,500 |
| Common Stock, $20 par | 900,000 | 600,000 | 1,500,000 |
| Additional Paid-in Capital | 270,000 | 510,000 (2) | 780,000 |
| Retained Earnings | 272,000 | | 272,000 |
| Total Liabilities and Equity | $1,877,900 | | $3,560,400 |

**Problem 2-5 (continued)**

| Change in Cash | |
|---|---|
| Cash from stock issue ($37 × 30,000) | $1,110,000 |
| Less: Cash paid for acquisition | (800,000) |
| Plus: Cash acquired in acquisition | 95,000 |
| Total change in cash | $ 405,000 |

| Goodwill: | |
|---|---|
| Cost of acquisition | $1,100,000 |
| Net assets acquired ($340,000 + $179,500 + $184,000) | 703,500 |
| Excess cost over net assets acquired | $396,500 |
| Assigned to plant assets | 215,000 |
| Goodwill | $ 181,500 |

(1) $690,000 + $215,000      (2) ($37 - $20) × 30,000

**Problem 2-6**

Ping Company
Pro Forma Income Statement for the Year 2011
Assuming a Merger of Ping Company and Spalding Company

| | | |
|---|---|---|
| Sales (1) | | $6,345,972 |
| Cost of goods sold: | | |
| Fixed Costs (2) | $824,706 | |
| Variable Costs (3) | 2,464,095 | 3,288,801 |
| Gross Margin | | 3,057,171 |
| Selling Expenses (4) | $785,910 | |
| Other Expenses (5) | 319,310 | 1,105,220 |
| Net Income | | $1,951,951 |

$$\frac{\$1{,}951{,}951 - (\$952{,}640 + \$499{,}900)}{0.20} = \frac{\$499{,}411}{0.20} = \$2{,}497{,}055$$

Since $2,497,055 is greater than $1,800,000 Ping should buy Spalding.

(1) $3,510,100 + $2,365,800 = $5,875,900 × 1.2 × .9 = $6,345,972

(2) ($1,752,360 × .30) + ($1,423,800 × .30 × .70) = $824,706

(3) $\$1{,}752{,}360 \times .70 \times \frac{\$5{,}875{,}900 \times 1.2}{\$3{,}510{,}100} =$ $2,464,095

(4) ($632,500 + $292,100) × .85 = $785,910

(5) $172,600 × 1.85 = $319,310

**Problem 2-7A**

**Part A**

| | | Debit | Credit |
|---|---|---|---|
| Receivables | | 125,000 | |
| Inventory | | 195,000 | |
| Land | | 120,000 | |
| Plant Assets | | 567,000 | |
| Patents | | 200,000 | |
| Deferred Tax Asset ($60,000 x 35%) | | 21,000 | |
| Goodwill* | | 154,775 | |
| | Current Liabilities | | 89,500 |
| | Bonds Payable | | 300,000 |
| | Premium on Bonds Payable | | 60,000 |
| | Deferred Tax Liability | | 93,275 |
| | Common Stock (30,000 × $2) | | 60,000 |
| | Other Contributed Capital (30,000 × $26) | | 780,000 |

| | |
|---|---|
| Cost of acquisition (30,000 × $28) | $840,000 |
| Book value of net assets acquired ($120,000 + $164,000 + $267,000) | 551,000 |
| Difference between cost and book value | 289,000 |
| Allocated to: | |
| Increase inventory, land, plant assets, and patents to fair value | (266,500) |
| Deferred income tax liability (35% × $266,500) | 93,275 |
| Increase bonds payable to fair value | 60,000 |
| Deferred income tax asset (35% × $60,000) | (21,000) |
| Balance assigned to goodwill | $154,775 |

**Part B**

| | | Debit | Credit |
|---|---|---|---|
| Income Tax Expense (Balancing amount) | | 148,006 | |
| Deferred Tax Liability ($51,125 × 35%)* | | 17,894 | |
| | Deferred Tax Asset ($6,000 × 35%) | | 2,100 |
| | Income Tax Payable ($468,000 × 35%) | | 163,800 |

| * | |
|---|---|
| Inventory: | $28,000 |
| Plant Assets, $\frac{\$100,000}{10}$ | 10,000 |
| Patents, $\frac{\$105,000}{8}$ | 13,125 |
| Total | $51,125 |

# CHAPTER TWO – ACCOUNTING FOR BUSINESS COMBINATIONS

## I. METHOD OF ACCOUNTING FOR NET ASSET ACQUISITIONS: PURCHASE OR ACQUISITION ACCOUNTING

A. Accounting standards now mandate the use of the acquisition (purchase) method for accounting for mergers & acquisitions. Until 2001, companies had a choice, albeit strictly regulated, between these two methods:

1. Pooling of interests – previous standards clearly defined the criteria necessary to qualify for this accounting treatment, and the SEC was involved in its enforcement.

2. Acquisition (Purchase) - all other combinations (i.e, those not qualifying for pooling treatment) were always accounted for by the purchase method, as all combinations are currently.

## II. PRO FORMA STATEMENTS AND DISCLOSURE REQUIREMENT

A. Pro forma statements have historically served two functions in relation to business combinations:

1. To provide information in the *planning* stages of the combination, and
2. To *disclose* relevant information subsequent to the combination. Note: This aspect was particularly important prior to the elimination of the pooling method, as a means of enabling users to compare mergers despite the dissimilarity on the face of the principal statements between those accounted for under purchase and pooling.

B. The term “pro forma” is also frequently used, aside from mergers, to indicate any calculations which are computed “as if” alternative rules or standards had been applied. For example, a firm may disclose in its press releases that earnings excluding certain one-time charges reflect a more positive trend than the GAAP-reported EPS. However, the SEC has recently cracked down on the extent to which these types of pro forma calculations may be presented, and the details that should be included in such announcements.

C. The notes to the statements contain useful information to facilitate comparison between periods.

## III. EXPLANATION AND ILLUSTRATION OF ACQUISITION ACCOUNTING

## Chapter 2

A. If cash is used, payment equals cost; if debt securities are used, present value of future payments represents cost.

B. Assets acquired via issued shares are recorded at fair values of the stock given or the assets received whichever is more clearly evident.

C. If stock is actively traded, market price is a better estimate of fair value than appraisal values.

D. Goodwill (GW) is recorded as any excess of total cost over the sum of amounts assigned to identifiable assets and liabilities and, under *SFAS No. 142* [ASC 350] is no longer amortized.

E. Goodwill must be tested for impairment at a level referred to as a reporting unit – generally a level lower than that of the entire entity. If the implied fair value of the reporting unit's goodwill is less than its carrying amount, goodwill is considered impaired.

F. Goodwill impairment losses should be aggregated and presented as a separate line item in the operating section of the income statement.

G. Bargain acquisition—when the net amount of fair values of identifiable assets less liabilities *exceeds* the total cost of the acquired company—a gain is recognized in the period of the acquisition under current GAAP.

H. When S Company acquires P Company with stock, common stock is credited for the par value of the shares issued, with the remainder credited to other contributed capital. Individual assets acquired and liabilities assumed are recorded at their fair values. Plant assets and other long-lived assets are recorded at their fair values unless a bargain has occurred, in which case their values are reduced below fair value to the extent of the bargain. When the cost exceeds the fair value of identifiable net assets, any excess of cost over the fair value is recorded as goodwill.

I. Income Tax Consequences of Acquisition Method Business Combinations: deferred tax assets and/or liabilities must be recognized for differences between the assigned values and tax bases of the assets and liabilities acquired. Such differences are likely when the combination is tax-free to the sellers.

## IV. CONTINGENT CONSIDERATION IN A PURCHASE

A. Contingency—transfer of assets subsequent to acquisition from parent to subsidiary, generally dependent of some measure of performance.

B. Contingency based on earnings is probably the most common, but it may create conflicts upon implementation because of measures which are out of the control of certain managers after the merger, as well as creating possible incentives for manipulation of earnings numbers (and may lead to decisions which are short-term rather than long-term focused).

C. Contingency based on security prices serves to correct some of the shortcomings of contingency calculations based on earnings (manipulation of numbers, for example), but leads to its own set of problems; for example, market prices fluctuate in response to many economy-wide factors that are almost completely outside the managers' control.

## V. LEVERAGED BUYOUTS

A. Group of employees/management creates a new company to acquire all the outstanding shares of employer/original company.

B. Consensus position is that only portion of the net assets acquired with borrowed funds have actually been purchased and therefore recorded at cost.

## APPENDIX A: Deferred Taxes in Business Combinations

A. Motivation for selling firm: structure the deal so that any gain resulting is tax-free at the time of the combination.

B. Deferred tax liability (or asset) needs to be recognized by purchaser when the book value of the assets is used (inherited) for tax purposes, but the fair value is recognized in the accounting books under purchase accounting rules.

**Chapter 2**

**APPENDIX B: Did Firms Prefer Pooling; And, If So, Why?**

I. A. Some facts about pooling

1. Majority of US mergers did not meet pooling criteria. Therefore the purchase method was more widely used, but firms (especially in large mergers) sometimes went to great lengths to qualify for pooling treatment. Furthermore, when the elimination of the pooling method was proposed, it meant with vehement protests from a number of fronts.

2. Why did firms care? The two methods resulted in a substantial difference in the way the combined financial statements appeared.

3. Pooling—neither of the two firms was considered dominant. The acquiring firm was termed the "issuer" and the other firm was the "non-issuer." Assets, liabilities, and retained earnings were taken forward at their previous carrying amounts. Operating results of the two companies were combined for the entire period being presented, regardless of the date of acquisition. Previously issued statements (when presented) were restated as if the companies had always been combined.

4. Pooling--income statements subsequent to the transaction did not include goodwill amortization, excess depreciation, or other charges due to asset revaluing.

5. Purchase accounting yields a generally lower net income divided by a larger base of assets, and therefore a substantially decreased return on assets (ROA) in most cases relative to pooling. However, this effect has been lessened by another FASB change which essentially eliminates the amortization of goodwill.

6. Pooling required review of prior year statements which facilitated trend analysis.

7. See Illustration 2-1 for comparison of the two methods

8. Balance sheet differences—Purchase accounting reflects more current values for the combining firm's assets and liabilites. Pooling combined retained earnings of the two firms (in most cases), leading to generally greater retained earnings balances for the combined entity relative to purhase. Purchase, on the other hand, does not reflect any retained earnings from the acquired entity.

B. Treatment of Acquisition Expenses Contrasted

1. Pooling—all types of expenses (direct, indirect, and security issue costs) were expensed in the period incurred.

2. Purchase—each category of expenses is treated differently, as shown below.

| | Pooling | Purchase |
|---|---|---|
| Direct Expenses | Expense (IS) | Capitalize (GW or PPE) |
| Indirect Expense | Expense (IS) | Expense |
| Security Issue Costs | Expense (IS) | Adjust additional PIC |

C. PURCHASE VERSUS POOLING -- AUTHORITATIVE POSITION (AND HISTORICAL PERSPECTIVE)

1. The Financial Accounting Standards Board (FASB) has recently eliminated the pooling method. As a result, all acquisitions are now accounted for by the purchase method.

2. Prior to the issuance of APB *Opinion No. 16*, "Business Combinations," the pooling method was widely used and abused. This opinion delineated the specific conditions under which pooling was required; all other combinations had to be accounted for as purchases.

a. Paragraphs 45--48 of *Opinion No. 16* spelled out the specific conditions under which pooling was required.
b. Twelve conditions in *Opinion No. 16* were specified to meet requirements for pooling.
c. *Opinion No. 16* attempted to define criteria clearly, remove any choice of method (other than that provided by judicious planning of a combination's terms), and prohibit partial pooling.

3. Advantages and disadvantages, both theoretical and practical, were noted for both methods.

4. *Opinion No. 16*, issued in 1970, significantly reduced the proportion of business combinations accounted for as poolings of interests and improved business combination accounting and reporting to a large extent. However, pooling remained a popular and controversial method for very large mergers until FASB eliminated it in 2001.

**Chapter 2**

II. A LOOK BACK: EXPLANATION AND ILLUSTRATION OF POOLING OF INTERESTS

A. Business combination process in which two or more groups of stockholders united their ownership interests by an exchange of common stock.

B. Owners retained proprietary rights

C. Fair value of assets and liabilities were ignored except in the determination of an equitable exchange ratio of common stock. Assets and liabilities were carried forward at book value.

D. Equity allocation to common stock, to other contributed capital and to retained earnings:

1. If par value of shares issued equals par value of existing shares on books of the combining firm—show addition of all other contributed capital and retained earnings.

2. If par value of shares issued exceeds par value of existing shares—equity transfer rule—*when the par (or stated) value of the shares issued by the issuing firm exceeds the total par or stated value of the combining company" stock, the excess should be deducted first from the combined other contributed capital and then from combined retained earnings (RE).*

3. If par value of shares issued is less than par value of existing shares on books of the combining firm—show addition of other contributed capital and retained earnings plus additional "other contributed capital" for the difference between par values.

4. Results of operations for that period were the sum of the results of:
   (1) Operations of the separate companies as if they had been combined from the beginning of the fiscal period to the date the combination is consummated.
   (2) The combined operations from that date to the end of the period.

III. FINANCIAL STATEMENT DIFFERENCES BETWEEN ACCOUNTING METHODS

A. Purchase and pooling of interest methods were not intended to be considered as alternatives in accounting for a specific business combination. Nonetheless business managers often regarded them as such in the planning stages of an acquisition. Furthermore, those acquisitions that were initially recorded under the pooling rules remain on the books under those rules; i.e. the elimination was not retroactive. Thus, it is

important to realize that so long as those companies do not unwind or spin off such prior acquisitions, the "old" pooling rules will continue to affect the appearance of financial statements for years to come.

B. Purchase accounting tends to report higher asset values but lower earnings (due to excess depreciation and amortization) versus pooling of interest.

C. Bargain purchases—purchase price below fair value of identifiable net assets—will yield ordinary gain under acquisition (purchase) rules. (In the past, extraordinary gains were sometimes recorded.)