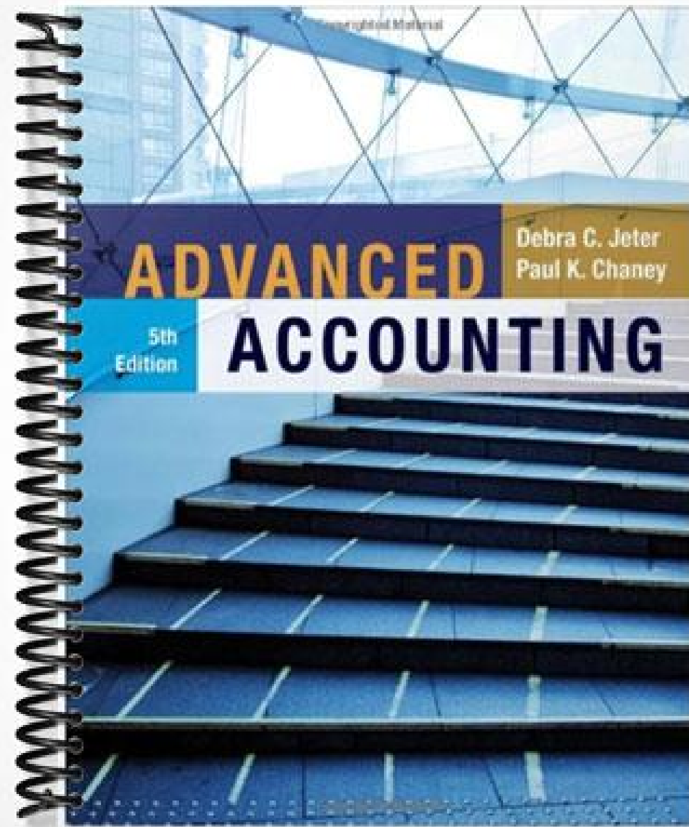
SOLUTIONS MANUAL



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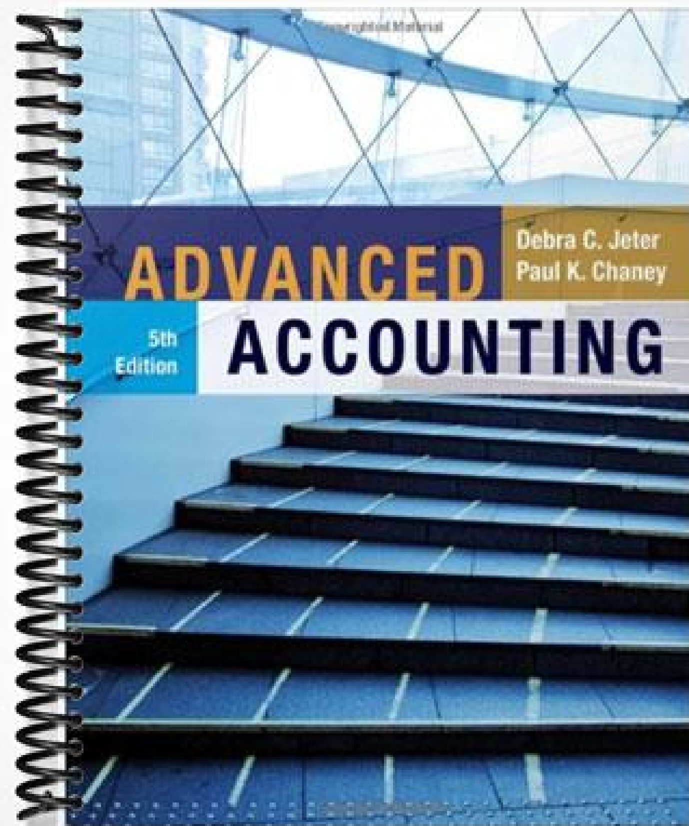


CHAPTER 2

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* (codified in FASB ASC 805-30-35) 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 ANALYZING FINANCIAL STATEMENTS EXERCISES

AFS2-1 eBay acquires Skype

(A) Goodwill computation

Acquisition price	$ 2,593	million
Net tangible and intangible assets	262	million
Goodwill	$ 2,331	million

(B) Factors used to determine in the contingent consideration is part of the exchange or not. (FASB ASC paragraphs 805-10-55-24 and 25)

The acquirer should consider the following if the contingent payments are made to employees or selling shareholders.

1. Is the selling shareholder a continuing employee? If the contingent payment is canceled if the employee's employment is terminated, then the consideration might be post-acquisition compensation for services.
2. If the selling shareholder is a continuing employee and the period of required continuing employment is longer than the contingent payment period, the contingent payments might, in substance, be compensation.
3. If the selling shareholder is a continuing employee and the employee's compensation is reasonable in comparison to other key employees, the contingent payment may indicate additional consideration rather than compensation.
4. If the contingent payment for non-employees is less than the contingent payments for continuing employees, the additional contingent payments for employees may indicated compensation rather than additional consideration.

(C) It is not clear why eBay would settle the earnout for $530.3 million when it is not clear that the conditions for having to make the additional contingent payments (up to $1.3 billion) were probably not going to be made. Under current GAAP, if the amount of the contingent payment exceeded the previously expected amount, the difference is reflected in earnings. Under the rules in effect for the Skype transaction the contingent

payment was simply an adjustment of goodwill. Because eBay was settling the earnout for approximately a third of the total potential payments indicates that Skype was not performing well. Notice that eBay wrote down$1.39 billion in goodwill at the same time. One potential reason that eBay might have agreed to the payment is that the former CEO of Skype was stepping down and the contingent payment may have been incentive. In addition, the earnout may have prevented eBay from selling Skype.

AFS2-2 eBay Sells Skype	As Reported			Adjustments			Adjusted		
eBay's Income Statement	2007	2008	2009	2007	2008	2009	2007	2008	2009
Net revenues	$7,672,329	$8,541,261	$8,727,362	-364,564	-550,841	-620,403	$7,307,765	$7,990,420	$8,106,959
Cost of net revenues	1,762,972	2,228,069	2,479,762	-337,338	-434,588	-462,701	1,425,634	1,793,481	2,017,061
Gross profit	5,909,357	6,313,192	6,247,600	(27,226)	(116,253)	(157,702)	5,882,131	6,196,939	6,089,898
Operating expenses:									
Sales and marketing	1,882,810	1,881,551	1,885,677				1,882,810	1,881,551	1,885,677
Product development	619,727	725,600	803,070				619,727	725,600	803,070
General & administrative	904,681	998,871	1,418,389			(343,200)	904,681	998,871	1,075,189
Provision for trans. & loan losses	293,917	347,453	382,825				293,917	347,453	382,825
Amortization of acquired intangible assets	204,104	234,916	262,686				204,104	234,916	262,686
Restructuring		49,119	38,187				-	49,119	38,187
Impairment of goodwill	1,390,938			(1,390,938)			-	-	-
Total operating expenses	5,296,177	4,237,510	4,790,834	(1,390,938)		(343,200)	3,905,239	4,237,510	4,447,634
Income from operations	613,180	2,075,682	1,456,766	1,363,712	(116,253)	185,498	1,976,892	1,959,429	1,642,264
Interest and other income	137,671	107,882	1,422,385			(1,400,000)	137,671	107,882	22,385
Income before income taxes	750,851	2,183,564	2,879,151	1,363,712	(116,253)	(1,214,502)	2,114,563	2,067,311	1,664,649
Provision for income taxes	(402,600)	(404,090)	(490,054)						
Net income	$348,251	$1,779,474	$2,389,097						
Ratios	2007	2008	2009				2007	2008	2009
Gross Margin Percentage	77.0%	73.9%	71.6%	7.5%	21.1%	25.4%	80.5%	77.6%	75.1%
Operating Margin Percentage	8.0%	24.3%	16.7%				27.1%	24.5%	20.3%
Income before taxes %	9.8%	25.6%	33.0%				28.9%	25.9%	20.5%

There are four adjustments to eliminate the effect of Skype from eBay's books. First, we eliminate the revenues and the direct expenses

AFS2-2 solution continued:

from each year. We eliminated 100% of Skype's revenues and direct expenses disclosed in the footnotes in 2009 because it was not clear from the disclosure whether those amounts were the amounts included on eBay's statements or whether they were for the entire year. An acceptable solution would be to eliminate 11.5/12 or 95.8%. Second, the impairment of goodwill was added back in 2007. Third, the gain on the sale of $1.4 million was subtracted from interest and other income in 2009. And finally, the charge from the legal settlement was added back (or subtracted from costs) in 2009.

Performance: Including Skype, eBay's gross margin declined from 77% to 71.6%. Without Skype, the gross margin still declined, but the decline was smaller (80.5% to 75.1%). Including Skype, income before taxes showed a rather large increase in absolute dollars increasing to $2,879,151 from $648,251 (283% increase). After Skype is eliminated we find a decreasing trend from $2,114,563 to 1,664,649 (a 21.3% decline). A similar trend exists for the income before tax as a percentage of revenues. The unadjusted percentage increased from 9.8% to 33% while the adjusted percentage decreased from 28.9% to 20.5%. The most interesting aspect of the numbers is that eBay recorded an impairment charge of $1.4 million in 2007 and then in 2009 recorded an $1.4 million gain on the sale.

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 Acquisition of Saville - Ordinary ($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

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 of acquisition ($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

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 - Issuable		500,000
Part B	Paid-in-Capital for Contingent Consideration - Issuable	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 × $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 × $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

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.

		Debit	Credit
2011:	Impairment Loss—Goodwill	15,000	
	Goodwill		15,000
2012:	No entry		
2013:	Impairment Loss—Goodwill	35,000	
	Goodwill		35,000

Part C.

FASB ASC paragraph 350-20-45-1 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, *FASB ASC paragraph 350-20-45-2* 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 ASC (Accounting Standards Codification) EXERCISES

ASC2-1 Presentation Does current GAAP require that the information on the income statement be reported in chronological order with the most recent year listed first, or is the reverse order acceptable as well?

Alternative one:

Step 1: In the search box on the home page, enter 'chronological order'.

Step 2: Two results are obtained.

Alternative two:

Step 1: Use the drop-down menus under the 'presentation' general topic on the homepage and choose 'Presentation of financial statements'; then under the second drop-down menu, choose '10-overall'.

Step 2: Click on the 'Expand' option and scroll through the topics looking for 'chronological order'. The very last line is SAB Topic 11.E Chronological Ordering of Data.

FASB ASC 205-10-S99-9 under SEC guidance indicates that the SEC staff have not preference in what order the data are presented (e.g., the most current data displayed first, etc.) as long as all schedules in the report are ordered in the same chronological order.

ASC2-2 General Principles In the 1990s, the pooling of interest method was a preferred method of accounting for consolidations by many managers because of the creation of instant earnings if the acquisition occurred late in the year. Can the firms that used pooling of interest in the 1990s continue to

use the method for those earlier consolidations, or were they required to adopt the new standards for previous business combinations retroactively?

This issue is related to whether the rules for pooling of interest have been grandfathered or not.
Alternative one:
Step 1: Below the search box on the home page, click on 'advanced search.' Enter 'Pooling of interests' in the text/keyword box and click on exact phrase.
Step 2: Three results are obtained and the first alternative is the correct answer.

Alternative two:
Step 1: Use the drop-down menus under the 'General Principles' general topic on the homepage and choose 'Generally Accepted Accounting Principles'; then under the second drop-down menu, choose '10-overall'.
Step 2: Section 70 is always the section for grandfathered guidance.

FASB ASC subparagraph 105-10-70-2(a) lists pooling of interests is listed as a grandfathered method.

ASC2-3 **Glossary** What instruments qualify as cash equivalents?

On the Codification homepage, click on 'Master Glossary' in the left-hand column. In the 'glossary term quick find' menu type 'cash equivalent' and hit return.

Cash equivalents are short-term, highly liquid investments that have both of the following characteristics:

a. Readily convertible to known amounts of cash
b. So near their maturity that they present insignificant risk of changes in value because of changes in interest rates.

ASC2-4 **Overview** If guidance for a transaction is not specifically addressed in the Codification, what is the appropriate procedure to follow in identifying the proper accounting?

The topic that established the Codification as authoritative GAAP is Topic 105.
Step 1: Use the drop-down menus under the 'General Principles' general topic on the homepage and choose 'Generally Accepted Accounting Principles'; then under the second drop-down menu, choose '10-overall'.
Step 2: click on the red 'Join all Sections' button. Scroll through the paragraphs.

FASB ASC paragraph 105-10-05-2 states that if the guidance for a transaction or event is not specified within a source of authoritative GAAP for that entity, an entity shall first consider accounting principles for similar transactions or events within a source of authoritative GAAP for that entity and then consider nonauthoritative guidance from other sources.

ASC2-5 General List all the topics found under General Topic 200—Presentation (*Hint:* There are 15 topics).

Presentation

205 Presentation of Financial Statements
210 Balance Sheet
215 Statement of Shareholder Equity
220 Comprehensive Income
225 Income Statement

230 Statement of Cash Flows
235 Notes to Financial Statements
250 Accounting Changes and Error Corrections
255 Changing Prices
260 Earnings Per Share

270 Interim Reporting
272 Limited Liability Entities
274 Personal Financial Statements
275 Risks and Uncertainties
280 Segment Reporting

ASC2-6 Cross-Reference The rules providing accounting guidance on subsequent events were originally listed in *FASB Statement No. 165*. Where is this information located in the Codification? List all the topics and subtopics in the Codification where this information can be found (i.e., ASC XXX-XX).

Step 1: Choose the cross reference tab on the opening page of the Codification.
Step 2: Use the 'By Standard' drop down menu. Choose FAS as the standard type and 165 as the standard number. Click on 'Generate Report.'

FASB ASC subtopic 855-10 [, Subsequent Events – Overall]

ASC2-7 Overview Distinguish between an asset acquisition and the acquisition of a business.

This is a more difficult issue to find.
Alternative one:
Step 1: Below the search box on the home page, click on 'advanced search.' Enter 'asset acquisition' in the text/keyword box and click on exact phrase.
Step 2: Sixteen results are obtained. You can narrow the search by clicking on 'business combinations' in the Narrow by related term section. Then, notice that the section on 'related issues' seems to be where acquisition of assets rather than a business is located.

FASB ASC paragraph 805-50-05-3 states that the guidance in the 'acquisition of assets rather than a business' subsections address transactions in which the assets acquired and liabilities assumed do not constitute a business. A business is considered an integrated set of activities and assets that is capable

of being conducted and managed for the purpose of providing a return in the form of dividends, lower costs, or other economic benefits directly to investors or other owners, members, or participants.

Alternative two:
Step 1: Use the drop-down menus under the 'Broad Transactions' general topic on the homepage and choose 'Business Combinations'; then under the second drop-down menu, choose '10-overall'. Expand the sections. Since nothing is listed related to the search, go to the scope section (805-10-15). FASB ASC subparagraph 805-10-15-4(b) tells you the scope of section 10 does not cover asset acquisitions.
Step 2: Go back and search for 'asset acquisition.

ASC2-8 **Measurement** GAAP requires that firms test for goodwill impairment on an annual basis. One reporting unit performs the impairment test during January while a second reporting unit performs the impairment test during July. If the firm reports annual results on a calendar basis, is this acceptable under GAAP?

This can be a difficult issue to find depending on the student's knowledge of goodwill. If a general search is used with the term 'goodwill impairment' the correct section can be found. The student must be aware that 'subsequent measurement' would be related to impairment testing of goodwill since impairment tests are subsequent measurements of goodwill. However, since the correct paragraph is paragraph 28, a lot of scrolling is needed.

Alternative two
Step 1: Use the drop-down menus under the 'Assets' general topic on the homepage and choose '350 – Intangibles-Goodwill and other'; then under the second drop-down menu, choose '20-Goodwill'. Expand the sections. Since nothing is listed related to the search, go to the scope section (805-10-15). FASB ASC subparagraph 805-10-15-4(b) tells you the scope of section 10 does not cover asset acquisitions.
Step 2: click on subsequent measurement and click on 'expand' topics. One of the topics is 'when to test goodwill impairment'.

FASB ASC paragraph 350-20-35-28 states that different reporting units may be tested for impairment at different times.

ANSWERS TO PROBLEMS

Problem 2-1

	Debit	Credit
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

	Debit	Credit
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

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 Acquisition of Stalton (ordinary)		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

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

Cost of Acquisition ($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 Net Assets of Salt Company
December 31, 2010

	Audited Balance Sheet	Adjustments	Pro Forma Balance Sheet
Cash	$180,000	405,000	$585,000
Receivables	230,000	(60,000) 117,000	287,000
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) 180,000	$375,900
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

NOTE: In this problem, Part B states that fixed manufacturing expenses have been 35% of cost of goods for each company and that variable manufacturing expense of Ping Company is 70% of cost of goods sold. This is an error because the percentages must equal 100%. For this solution, use 30% for fixed manufacturing expenses.

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 2

Accounting for Business Combinations

BRIEF OUTLINE

2.1 Historical Perspective on Business Combinations
2.2 Goodwill Impairment Test
2.3 Disclosures Mandated by FASB
2.4 Other Intangible Assets
2.5 Treatment of Acquisition Expenses
2.6 Pro Forma Statements and Disclosure Requirements
2.7 Explanation and Illustration of Acquisition Accounting
2.8 Contingent Consideration in an Acquisition
2.9 Leveraged Buyouts
2.10 IFRS versus U.S. GAAP
2.11 Appendix A: Deferred Taxes in Business Combinations

INTRODUCTION

This chapter introduces you to the new technique for recording a business combination. It also gives you some background on how the new rules evolved, and what was done before the recent changes. There are some important illustrations in the book concerning the techniques.

CHAPTER OUTLINE

2.1 Historical Perspective on Business Combinations

A. Historically, there were two methods
   1. Purchase
   2. Pooling of interests – restricted by APB Opinion No. 16 in 1970

B. New rules
   1. SFAS No. 141 discontinued the "pooling method" and allows for the "purchase method" only.
   2. SFAS No. 141R replaced SFAS 141. Only one method is allowed, the "acquisition method".
   3. SFAS No. 141R requires that fair values of all assets and liabilities on the acquisition date, defined as the date the acquirer obtains control of the acquire, be reflected in financial statements.
   4. These topics are now codified in FASB ASC Topic 805 [Business Combinations].
   5. SFAS No. 142, now included in FASB ASC Topic 810 [Consolidations], changes the way goodwill is accounted for at acquisition and FASB ASC Topic 350 how goodwill is accounted for subsequent to acquisition.
   6. FASB ASC Topic 810 [Consolidations] on reporting for non-controlling interests is covered in Chapter 3.
   7. The new standards try to overcome criticisms that have haunted the accounting for some time:
      a. Differences between U.S. GAAP and International Financial Reporting Standards
      b. Lack of consistency, understandability and usefulness in accounting for step acquisitions
   8. The essence of the changes is that the acquired business should be recognized at its fair value on the acquisition date (defined as the date when control is obtained), rather than its cost.

2.2 Goodwill Impairment Test required by FASB ASC paragraph 350-20-35-18

A. Goodwill must be tested annually to see if its value has permanently declined.
   1. For "new" goodwill, the loss is current.
   2. For goodwill from acquisitions prior to the new ruling, the loss is treated as a change in accounting principle.

B. Technique

1. Goodwill is assigned to a reporting unit.
2. There is a two-step process.
    a. Step 1. Determine whether the carrying value of the reporting unit is greater than zero
        i. If CV < zero and circumstances suggest that it is more likely than not that goodwill has been impaired, step 2 is necessary
        ii. Such circumstances include unanticipated competition, loss of key personnel, and adverse regulatory action
    b. Step 2. Compare the carrying value of goodwill to its "implied fair value" (calculated as FV of reporting unit – FV of identifiable net assets)
        i. Same as original value calculation on date of acquisition
        ii. Acquisition price – FV of identifiable net assets = goodwill
3. When the loss is recognized, goodwill has a new carrying value which can't be written up
4. Other assets should be tested for impairment first

2.3. Disclosures Mandated by FASB

1. FASB ASC paragraph 805-30-50-1 includes disclosure for goodwill
    a. Total amount of goodwill acquired and amount expected to be tax deductible
    b. Amount of goodwill divided by reporting segment
2. FASB ASC paragraph 350-20-45-1
    a. Presentation in financial statements (if impairment occurs)
        i. Aggregate goodwill on a separate line on the balance sheet
        ii. Aggregate impairment loss in operating section of the income statement
    b. FASB ASC paragraph 350-20-50-2 included in notes to the financial statements
        i. Description of the circumstances
        ii. Amount of loss and method of determining FV of reporting unit
        iii. Nature and amounts of losses
    c. Transitional disclosure is required until all statements presented reflect the new ruling
3. FASB ASC paragraph 805-10-50-2 includes other required disclosures
    a. Name and description of acquiree
    b. The acquisition date
    c. The percentage of voting equity acquired
    d. The primary reasons for the business combination
    e. The fair value of acquiree and the basis of measuring the fair value
    f. The fair value of consideration transferred
    g. The amounts recognized for each major class of asset and liabilities
    h. The maximum potential amount of future payments

2.4 Other Intangible Assets

A. Acquired intangibles other than goodwill should be amortized over their limited economic lives and be reviewed for impairment in accordance with FASB ASC Section 350-30-35 [Intangibles – Subsequent Measurement]
B. Other intangibles with indefinite lives should not be amortized until their economic lives are determined. Instead it should be tested annually for impairment.

2.5 FASB ASC paragraph 805-10-25-23 treatment of acquisition expenses

A. Excluded from measurement of consideration paid
    1. Direct and indirect expenses are expensed
    2. Security issue costs are assigned to valuation of the securities

2.6 Pro Forma (as if) Statements and Disclosure Requirement

A. Pro forma statements serve two functions
    1. To provide information when planning the combination
    2. To disclose relevant information after the combination
B. Planning function

1. To estimate purchase price
2. To explain combination to stockholders
3. Must be clearly labeled pro forma

C. Notes to the financial statements should include
1. Results of operations as if the companies had been together all year
2. Results of operations of the prior year as if the companies had been together all year

2.7 Explanation of Acquisition Accounting

A. This method treats the combination as an acquisition of one company by another
1. The cost of the acquisition is cash and debt given
2. Assets by issuing stock
   a. Valued at fair value of stock issued or fair value of asset acquired, whichever is more clearly evident
   b. Quoted market price of stock is preferred fair value, if stock is actively traded
   c. For issued stock from new or closely held companies use the fair value of assets
3. Value implied by the purchase price is allocated to identifiable assets acquired and liabilities assumed, using fair values
4. Any excess of value implied by the purchase price exceeding the sum of the fair values of the net assets is recorded as goodwill, which is not amortized but can be adjusted for impairment
   a. This avoids creative manipulation in the valuation of assets
   b. In-process R&D that is acquired as part of a business combination is capitalized
5. If the fair values of the net assets exceed the value implied by the purchase price, the buyer has a "bargain acquisition." This amount is recognized in income.

B. Income Tax Consequences in Business Combinations Accounted for by the Acquisition Method
1. Fair values of net assets might be different from income tax valuations of those assets
2. Current GAAP requires deferred taxes be recorded for those differences

C Bargain Acquisition
1. Value implied by the purchase price is below the fair value of identifiable net assets
2. Any previously recorded goodwill on the seller's books is eliminated
3. An ordinary gain is recorded to the extent that the fair value of net assets exceeds the consideration paid.

2.8 Contingent Consideration in an Acquisition

A. Sometimes a purchase agreement includes a contingency in the contract
1. The purchaser might have to give more cash or securities if certain events happen
2. There's usually a stated contingency period, which should be disclosed
3. All contingent consideration must be measured and recognized at fair value on the acquisition date
4. Subsequent adjustments usually result from events or changes in circumstances that take place after the acquisition date and, thus, should not be treated as adjustments to the consideration paid.
5. Contingent consideration classified as equity shall not be remeasured

B. Adjustments during the Measurement Period
1. The measurement period is the period after the acquisition date during which the acquirer may adjust the provisional amounts recognized at the acquisition date.

   2. The measurement period ends as soon as the acquirer has the needed information about facts and circumstances, not to exceed one year from the acquisition date.
 C. Contingency based on both future earnings and stock prices – all additional contingent consideration is recorded

2.9 Leveraged Buyouts (LBOs)

 A. Leveraged buyouts occur when management and outside investors buy all the outstanding shares of stock and the old corporation becomes a new, closely-held corporation
   1. The management group gives whatever stock they hold
   2. Large amounts of money are borrowed (the “leverage”)
 B. LBOs are viewed as business combinations.

2.10 IFRS versus U.S. GAAP

 A. Project on business combinations was the first of several joint projects to move converge standards.
 B. Significant difference is that IFRS allows user choice of writing all assets including goodwill up fully (U.S. GAAP) or write goodwill up only to the extent of the parent’s percentage of ownership

2.11 Appendix A: Deferred Taxes in Business Combinations

 A. To the extent that the seller accepts common stock rather than cash or debt in exchange for the assets, the sellers may not have to pay taxes until a later date, when the shares accepted are sold
 B. In a non-taxable exchange, where the goodwill is not subject to amortization on either the tax return or the books, there is no obvious temporary difference
 C. In a taxable exchange, the excess amount of tax-deductible goodwill over the goodwill recorded in the books does meet a definition of temporary difference
 D. Changes in valuation allowance on deferred tax assets shown as income or expense in the period of the combination

MULTIPLE CHOICE QUESTIONS

Choose the BEST answer for the following questions.

_____ 1. The currently acceptable method(s) of accounting for a business combination is (are):
   a. statutory merger
   b. pooling of interests
   c. acquisition
   d. both acquisition and pooling

_____ 2. The general idea of the acquisition method is the:
   a. acquiring company is buying an asset.
   b. acquiring and the acquired companies are joining as if they were always together.
   c. acquisition always results in parent-subsidiary relationship.
   d. assets of the acquired company are recorded at their fair market values.

_____ 3. The advantages of an acquisition include:
   a. one company acquires another and control passes.
   b. the transaction is based on book values given and received.
   c. the companies report as if they had always been together.
   d. earnings per share are generally higher than in a pooling.

_____ 4. What is parent's cost in an acquisition?
   a. The par value of the stock issued
   b. The fair value of the net assets acquired
   c. The book value of the net assets acquired
   d. The cash, debt, or fair value of stock given up

_____ 5. What is goodwill?
   a. The excess of cost over fair value of net assets acquired
   b. The excess of cost over book value of net assets acquired
   c. The excess of fair value of net assets acquired over cost
   d. The amortized excess of fair value of assets acquired over their book value

_____ 6. What is the current technique for the disposition of goodwill acquired in a business combination?
   a. Amortized over some period not to exceed 40 years
   b. Amortized over some period not to exceed 20 years
   c. Expensed in the year of combination
   d. Capitalized at original value unless impairment occurs

_____ 7. What is a bargain acquisition?
   a. When parent's cost is far above the fair value of S's net assets acquired
   b. When parent cannot determine a fair value of its stock issued in the acquisition
   c. When parent purchases S for less than the fair market value of the net assets acquired
   d. When parent increases the value of the long-lived assets to reflect its excess cost

_____ 8. If parent offers a contingency based on earnings:
a. parent's original stockholders might be entitled to additional payments
b. subsidiary's original stockholders might be entitled to additional payments
c. the amounts determined are always added to the purchase price of the acquisition
d. there is concern from subsidiary's original stockholders that the purchase price offered by parent might be too high

_____ 9. Impairment of goodwill
a. causes the asset account to be decreased.
b. is the only time goodwill from a business combination is expensed.
c. cannot ever be reclaimed in future periods.
d. all of the above.

_____10. Which of the following is a *drawback* of an asset acquisition compared to a stock acquisition?
a. Since the target company does not persist as a separate entity, its liability and its regulated status, if any, may extend to the parent.
b. The consolidated statements reflect both historical cost and fair market values.
c. Parent can use a variety of resources to acquire subsidiary.
d. Fair values are sometimes difficult to objectively determine.

_____11. A leveraged buyout includes:
a. a group of employees and third party investors making a tender offer for all the common stock of a corporation.
b. most of the capital for the new corporation comes from debt.
c. treatment as business combination.
d. all of the above.

MATCHING

Match the terms in the list to the definitions below. Each term may be used only once.

A. Business combinations
B. Asset acquisition
C. Contingent acquisition
D. Goodwill
E. Pro forma statements
F. Impairment
G. Bargain acquisition
H. Leveraged buyout
I. Fair value
J. Book value
K. P's cost

_____ 1. The value recorded by S for its net assets before its acquisition by parent

_____ 2. An agreement to modify the price paid for a company for events that happen after the acquisition date

_____ 3. The amount determined by what P gives up in its acquisition of S

_____ 4. Convergence project by FASB and IASB

_____ 5. An acquisition where P pays less than the fair market value of S's net assets

_____ 6. The excess of cost over the fair value of S's net assets

_____ 7. A condition where P's acquired goodwill is determined to be less than originally calculated

_____ 8. A combination where P buys the net assets of S

_____ 9. A combination often financed by large amounts of debt

_____10. The value of net assets recorded in an acquisition

_____11. Statements prepared to reflect the impact of a business combination in the year of acquisition

EXERCISE

1. Proust Corporation is considering a merger with Seville Company. After considerable negotiations, the two companies determined that two shares of Seville Company stock would be replaced with one share of Proust stock. The balance sheets of the two companies are below, along with the fair value of Seville's identifiable net assets. At this time, Proust's stock is selling for $50 a share, and Seville's stock is selling for $25.

	Proust	Seville	Seville's Fair Values
Cash	$ 50,000	$ 30,000	$ 30,000
Receivables	20,000	15,000	14,000
Inventories	15,000	20,000	23,000
Plant & Equipment (Net)	150,000	80,000	95,000
Total Assets	$ 235,000	$ 145,000	
Liabilities	$ 25,000	$ 10,000	$ 10,000
Common Stock, $10 par	100,000	75,000	
Other Contributed Capital	50,000	20,000	
Retained Earnings	60,000	40,000	
Total Lia & Equities	$ 235,000	$ 145,000	

Required:

A. Assume the merger will be accounted for as an acquisition. Determine the value of the stock issued and the resulting cost of the merger to Proust. Determine any goodwill.

B. Prepare journal entries for the Proust Company after the merger.

SOLUTIONS

MULTIPLE CHOICE

1. C
2. D
3. A
4. D
5. A
6. D
7. C
8. B
9. D
10. A
11. D

MATCHING

1. J
2. C
3. K
4. A
5. G
6. D
7. F
8. B
9. H
10. I
11. E

EXERCISE

1. a. Seville's net assets at fair value:

Cash	$ 30,000
Receivables	14,000
Inventory	23,000
Plant & Equipment	95,000
Total Assets	$162,000
Liabilities	10,000
Fair value of Seville's net assets	$152,000

Proust's stock issued:

Seville's stock = $75,000/$10 par value = 7,500 shares
Proust issues 7,500/2 = 3,750 new shares × $50 market price = $187,500

Goodwill:

Proust's cost	$187,500
Fair value of Seville's net assets	152,000
Goodwill	$ 35,500

b.

To record Proust's purchase of Seville		
Cash	30,000	
Receivables	14,000	
Inventory	23,000	
Plant & Equipment	95,000	
Goodwill	35,500	
Liabilities		10,000
Common Stock [3,750 × $10 par]		37,500
Other Contributed Capital [3,750 × $40]		150,000

Chapter 2

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 method for accounting for mergers & acquisitions. Previously, companies had a choice, albeit strictly regulated, between these two methods: 1) the pooling of interests method (until June 30, 2001) and 2) purchase method (fiscal years beginning before December 31, 2008).

B. Under current GAAP the fair values of all assets and liabilities on the acquisition date, defined as the date the acquirer obtains control of the acquiree, are reflected in the financial statements.

1. The acquired business should be recognized at its fair value on the acquisition date rather than its cost, regardless of whether the acquirer purchases all or only a controlling percentage (even if the combination is achieved in stages).
2. The standards for business combinations now apply to business combinations involving only mutual entities, those achieved by contract alone, and the initial consolidation of variable interest entities (VIEs). VIEs are discussed in Chapter 3.

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.

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. If a material business combination (or series of combinations material in the aggregate) occurred during the year, *notes* to financial statements should include on a pro forma basis:

1. Results of operations for the current year as though the companies had combined at the beginning of the year, unless the acquisition was at or near the beginning of the year.

2. Results of operations for the immediately preceding period as though the companies had combined at the beginning of that period if comparative financial statements are presented.

III. EXPLANATION AND ILLUSTRATION OF ACQUISITION ACCOUNTING

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. Under FASB ASC paragraph 805-10-25-23, acquisition related costs are excluded from the measurement of the consideration paid, because such costs are not part of the fair value of the acquiree and are not assets.

a. Both direct and indirect expenses are expensed, and the cost of issuing securities is also excluded from the consideration paid. In the absence of more explicit guidance, we assume that security issuance costs reduce additional contributed capital for stock issues or adjust the premium or discount on bond issues.

E. 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.

F. 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. See Flowcharton the next page. .

Commented [S1]: I am not sure if the Flowchart will appear on the next page. Also, adding "D" may have created a spacing problem.

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

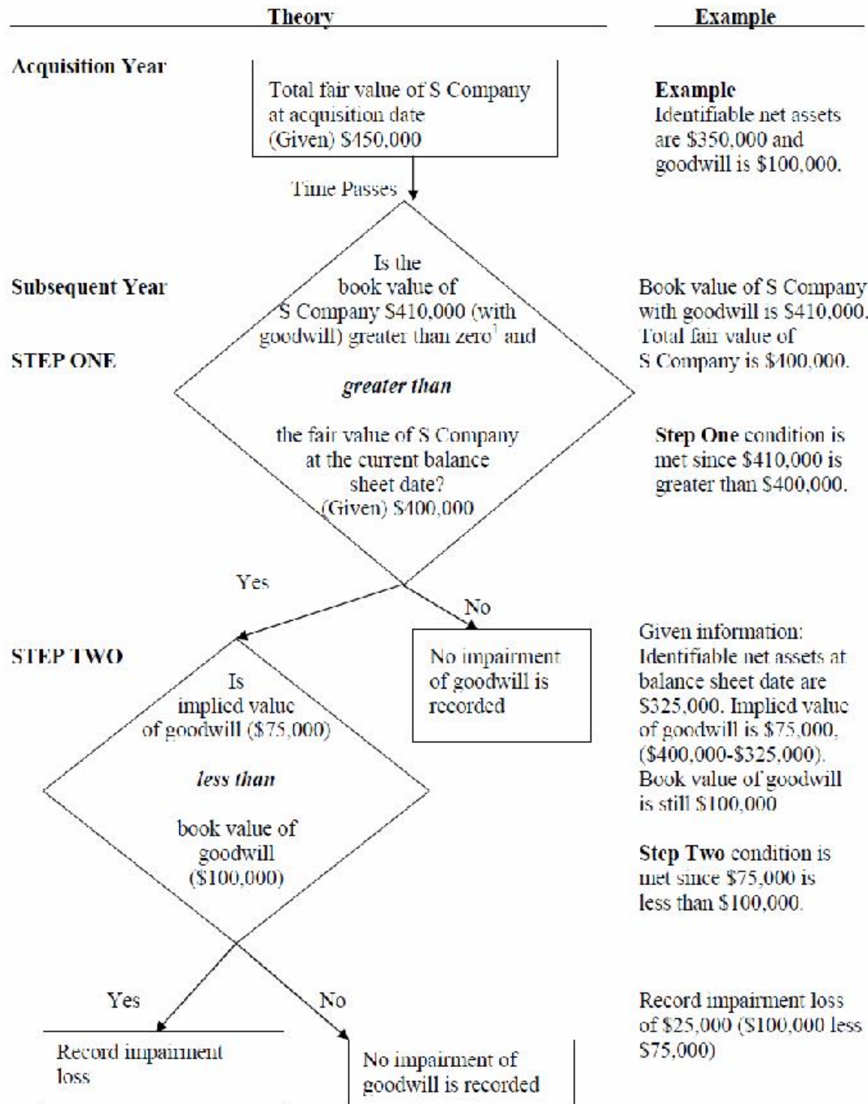
H. Bargain acquisition—when the net amount of fair values of identifiable assets less liabilities *exceeds* the total cost of the acquired company—a gain is recognized in the period of the acquisition under current GAAP.

I. 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. Bonds payable are recorded at their fair value by recognizing a premium or a discount on the bonds. When the cost exceeds the fair value of identifiable net assets, any excess of cost

over the fair value is recorded as goodwill.

J. Income Tax Consequences of Acquisition Method Business Combinations: deferred tax assets and/or liabilities should 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.

Chapter 2



Chapter 2

IV. CONTINGENT CONSIDERATION IN AN ACQUISITION

A. Contingency—transfer of assets (or other consideration) subsequent to acquisition to the seller, generally dependent on some measure of performance. Current GAAP requires that all contractual contingencies, as well as non-contractual liabilities for which it is **more likely than not** that an asset or liability exists, be measured and recognized at fair value on the acquisition date.

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.

Illustration 2-4
Deals with Contingent Payments
2000 to 2006
$ Billions

Year	No. of Deals	Value	Earn-out Value
2000	140	32.2	5.9
2001	120	20.7	6.1
2002	118	9.8	2.5
2003	92	29.2	5.0
2004	123	13.9	4.5
2005	127	19.5	4.6
2006	175	29.2	5.3

Source: *Mergers & Acquisitions*, February 2007.

Chapter 2

V. LEVERAGED BUYOUTS (LBO)

A. Group of employees/management and third-party investors create a new company to acquire all the outstanding shares of employer/original company. The management group contributes whatever stock they hold to the new corporation and borrows sufficient funds to acquire the remainder of the common stock.

1. The LBO term results because most of the capital of the new corporation comes from borrowed funds.

B. The basic accounting question relates to the net asset values (fair or book) to be used by the new corporation.

1. The economic entity concept should be applied; thus LBO transactions are viewed as business combinations.

Illustration 2-5
The Leveraged Buyout Market (LBO)
2000-2009

Year	No. of Deals	% of all Deals
2000	311	3.5%
2001	172	2.5%
2002	187	3.1%
2003	197	3.0%
2004	366	4.7%
2005	520	6.1%
2006	754	7.8%
2007	815	7.8%
2008	576	6.8%
2009	287	4.9%
2010	438	6.4%

Source: *Mergers and Acquisitions* February 2009, 2010, 2011

Chapter 2

VI. IFRS versus U.S. GAAP

Illustration 2-6
Comparison of Business Combinations and Consolidations under U.S. GAAP and IFRS[1]

U.S. GAAP	IFRS GAAP
1. Fair value of **contingent consideration** recorded at acquisition date, with subsequent adjustments recognized through earnings if contingent liability (no adjustment for equity).	1. IFRS 3R uses the same approach
2. **Contingent assets and liabilities** assumed (such as warranties) are measured at fair value on the acquisition date if they can be reasonable estimated. If not, they are treated according to *SFAS No. 5*.	2. Under IFRS 3R a contingent liability is recognized at the acquisition date if its fair value can be reliably measured.
3. **Noncontrolling interest** is recorded at fair value and is presented in equity.	3. Noncontrolling interest can be recorded either at fair value or at the proportionate share of the net assets acquired. Also presented in equity.
4. **Special purpose entities** (SPEs) are consolidated if the most significant activities of the SPE are controlled. Qualified SPE (QSPEs) are no longer exempted from consolidation rules.	4. Special purpose entities (SPEs) are consolidated if controlled. QSPEs are not addressed.
5. **Direct acquisition costs** (excluding the costs of issuing debt or equity securities) are expenses.	5. IFRS 3R uses the same approach.
6. **Goodwill** is not amortized, but is tested for impairment using a two-step process	6. Goodwill is not amortized, but is tested for impairment using a one-step process.
7. **Negative goodwill** in an acquisition is recorded as an ordinary gain in income (not extraordinary).	7. IAS 36 uses the same approach.
8. **Fair value** is based on exit prices, i.e. the price that would be received to sell an asset or paid to transfer a liability in an orderly transaction between market participants at the measurement date.	8. Fair value is the amount for which an asset could be exchanged or a liability settled between knowledgeable, willing parties in an arm's length transaction.
9. **Purchased in-process R&D** is capitalized with subsequent expenditures expensed. The capitalized portion is then amortized.	9. Purchased in-process R&D is capitalized with the potential for subsequent expenditures to be capitalized. The capitalized portion is then amortized.
10. Parent and subsidiary **accounting policies *do not need*** to conform.	10. Parent and subsidiary accounting policies ***do need*** to conform.
11. Restructuring plans are accounted for separately from the business combination and generally expensed (unless conditions in SFAS No. 146 [ASC 420] are met).	11. Similar accounting under IFRS 3 and amended IAS 27
12. Measurement period ends at the earlier of a) one year from the acquisition date, or b) the date when the acquirer receives needed information to consummate the acquisition.	12. Similar to U.S. GAAP
13. For step acquisitions, all previous ownership interests are adjusted to fair value, with any gain or loss recorded in earnings.	13. Similar to U.S. GAAP
14 Reporting dates for the parent and subsidiary can be different up to three months. Significant events in that time must be disclosed.	14. Permits a three-month difference if impractical to prepare the subsidiary's statements on the same date; however, *adjustments are required* for significant events in that period.
15. Potential voting rights are generally not considered in determining control	15. Potential voting rights are considered if currently exercisable.

Chapter 2

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 acquisition accounting rules.