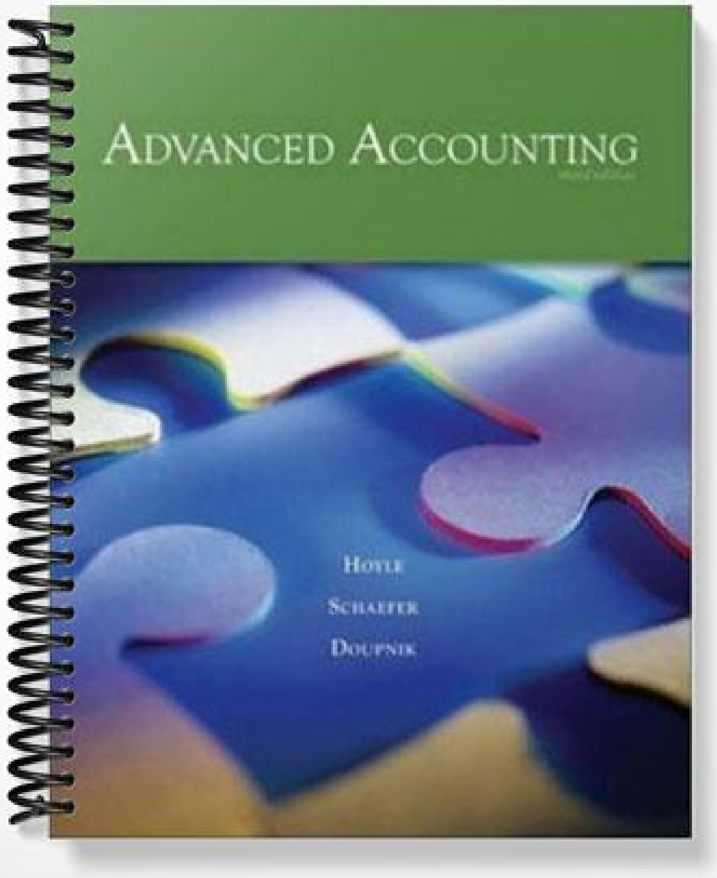
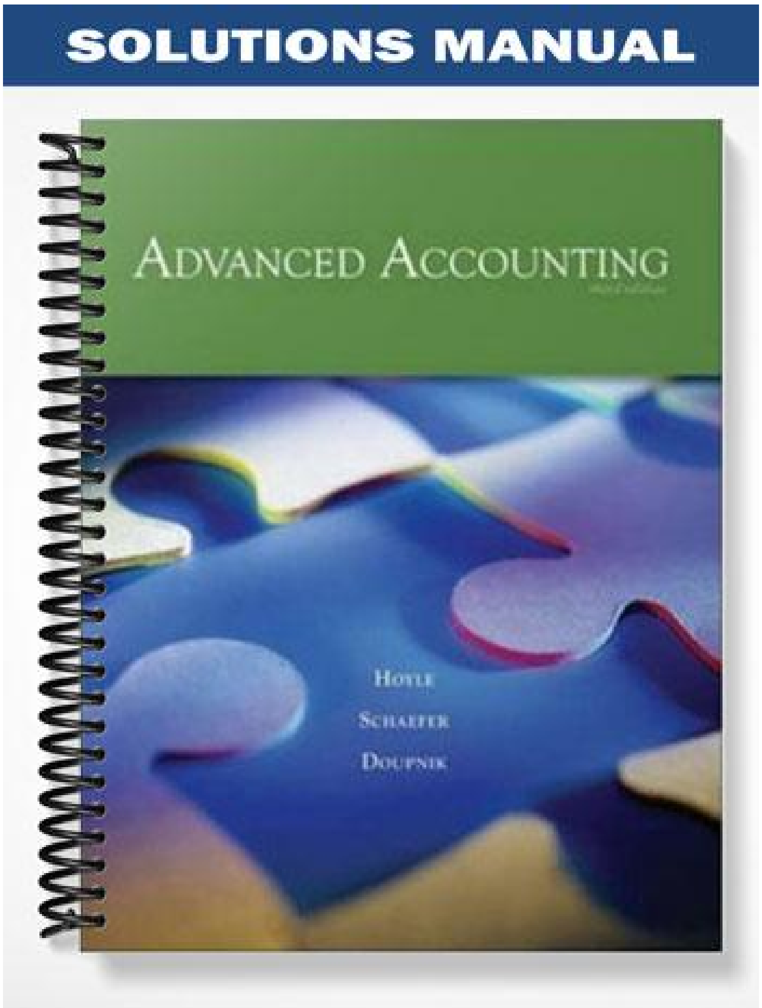
SOLUTIONS MANUAL




SOLUTIONS MANUAL
ADVANCED ACCOUNTING
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CHAPTER 2
CONSOLIDATION OF FINANCIAL INFORMATION

Major changes have occurred for financial reporting for business combinations. These changes are documented in *SFAS No. 141R*, "Business Combinations" and *SFAS No. 160*, "Noncontrolling Interests and Consolidated Financial Statements" (to replace *Accounting Research Bulletin* 51). These new pronouncements require the acquisition method instead of the purchase method. The acquisition method emphasizes fair values for recording all combinations as opposed to the cost-based provisions of *SFAS 141*.

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

Chapter Outline

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

II. The Acquisition Method

A. The acquisition method has been adopted by the FASB in *SFAS 141R* to replace the purchase method. For combinations resulting in complete ownership, it is distinguished by four characteristics.

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

B. *SFAS 141R* requires that in-process research and development acquired in a business combination be recognized as an asset at its acquisition-date fair value.

III. The Purchase Method

A. The purchase method was applicable for business combinations occurring for fiscal years beginning prior to December 15, 2008. It was distinguished by three characteristics.

1. One company was clearly in a dominant role as the purchasing party
2. A bargained exchange transaction took place to obtain control over the second company
3. An historical cost figure was determined based on the acquisition price paid
   a. The cost of the acquisition included any direct combination costs.
   b. Stock issuance costs were recorded as a reduction in paid-in capital and are not considered to be a component of the acquisition price.

B. Purchase method procedures where dissolution of the acquired company took place

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

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

C. Purchase method where separate incorporation of all parties was maintained.

1. Consolidation figures were the same as when dissolution took place.
2. A worksheet was normally utilized to simulate the consolidation process so that financial statements can be produced periodically.

IV. The Pooling of Interest Method (*SFAS 141* prohibits new poolings after June 30, 2001)

A. A pooling of interests is formed by the uniting of the ownership interests of two companies through the exchange of equity securities. The characteristics of a pooling are fundamentally different from either the purchase or acquisition methods.

1. Neither party was truly viewed as an acquiring company.
2. Precise cost figures stemming from the exchange of securities were difficult to ascertain.
3. The transaction affected the stockholders rather than the companies.

Prior to *SFAS 141* business combinations meeting twelve criteria established by the Accounting Principles Board (in its *Opinion 16*) were accounted for as a pooling of interests. If even one of the twelve was not satisfied, the combination was automatically viewed as a purchase.

B. Pooling of interests where dissolution occurred

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

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

Learning Objectives

Having completed Chapter Two, “Consolidation of Financial Information,” students should be able to fulfill each of the following learning objectives.

1. Understand that a single economic entity is formed by the uniting of two or more companies under the control of one party.
2. Understand the term “business combination.”
3. Differentiate between a statutory merger, a statutory consolidation, and a business combination formed when one company acquires control over another and both remain incorporated.
4. Realize that, if dissolution does not take place, the consolidation process must be repeated at periodic intervals whenever financial statements are produced for the single entity.
5. Understand the valuation principles of the acquisition method.
6. Determine the total fair value of the consideration transferred for an acquisition and allocate that fair value to specific subsidiary accounts (including in-process research and development assets), goodwill, or a gain on bargain purchase.
7. Prepare the journal entry to consolidate the accounts of a subsidiary if dissolution takes place.
8. Using the acquisition method, prepare a worksheet to consolidate the accounts of two companies that form a business combination if dissolution is not to take place.
9. Know the two criteria for recognizing intangible assets apart from goodwill acquired in a business combination.
10. Account for the direct costs incurred in forming a business combination.
11. Identify the general characteristics of the purchase method and the general characteristics of a pooling of interests.
12. Understand that although the pooling method and purchase methods are no longer applicable for new business combinations, that the prohibition is not retroactive. Thus the financial reporting effects of poolings will be with us for decades to come.
13. Understand the theoretical problems often associated with a pooling of interests.

Answers to Questions

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

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

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

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

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

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

7. The revenues and expenses (both current and past) of the **parent** are included within reported figures. However, the revenues and expenses of the subsidiary are only consolidated from the date of the acquisition forward. The operations of the subsidiary are only applicable to the business combination if earned subsequent to its creation.

8. Morgan's additional purchase price may be attributed to many factors: expected synergies between Morgan's and Jennings' assets, favorable earnings projections, competitive bidding to acquire Jennings, etc. In general however, under the acquisition method, any amount paid by the parent company in excess of the fair values of the subsidiary's net assets is reported as goodwill.

9. All of the subsidiary's asset and liability accounts are usually recorded at fair value (see Answer 6 above). Under the acquisition method, in the vast majority of cases the assets acquired and liabilities assumed in a business combination are recorded at their fair values. If the fair value of the consideration transferred (including any contingent consideration) is less than the total net fair value assigned to the assets acquired and liabilities assumed, then an ordinary gain is recognized for the difference.

10. Shares issued are recorded at fair value as if the stock had been sold and the money obtained used to acquire the subsidiary. The Common Stock account is recorded at the par value of these shares with any excess amount attributed to additional paid-in capital.

11. Under the acquisition method, direct combination costs are not considered part of the fair value of the consideration transferred and thus are not included in the purchase price. These direct combination costs are allocated to expense in the period in which they occur. Stock issue costs are treated under the acquisition method in the same way as under the purchase method, i.e., as a reduction of APIC.

Answers to Acquisition Method Problems

1. B

2. D

3. C

4. A

5. D

6. D

7. B

Consideration transferred (fair value)		$800,000
Fair value of *identifiable* assets		
Cash	$150,000	
A/R	140,000	
Software	320,000	
In-process R&D	200,000	
Liabilities	(130,000)	
Fair value of net *identifiable* assets acquired		680,000
Goodwill		$120,000

8. C Atkins records new shares at fair value

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

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

9. B

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

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

11. a. From *SFAS 141R* an intangible asset acquired in a business combination shall be recognized as an asset apart from goodwill if it arises from contractual or other legal rights (regardless of whether those contractual or legal rights are transferable or separable from the acquired enterprise or from other rights and obligations). If an intangible asset does not arise from contractual or other legal rights, it shall be recognized as an asset apart from goodwill only if it is separable, that is, it is capable of being separated or divided from the acquired enterprise and sold, transferred, licensed, rented, or exchanged (regardless of whether there is an intent to do so). An intangible asset that cannot be sold, transferred, licensed, rented, or exchanged individually is considered separable if it can be sold, transferred, licensed, rented, or exchanged with a related contract, asset, or liability.

b.

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

12. (15 Minutes) (Consolidated balances)

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

- Inventory = $670,000 (Parrot's book value plus Sun's fair value)
- Land = $710,000 (Parrot's book value plus Sun's fair value)
- Buildings and equipment = $930,000 (Parrot's book value plus Sun's fair value)
- Franchise agreements = $440,000 Parrot's book value plus Sun's fair value)
- Goodwill = $80,000 (calculated above)
- Revenues = $960,000 (only parent company operational figures are reported at date of acquisition)
- Additional Paid-in Capital = $65,000 (Parrot's book value less stock issue costs)
- Expenses = $940,000 (only parent company operational figures plus acquisition-related costs are reported at date of acquisition)
- Retained Earnings, 1/1 = $390,000 (Parrot's book value)

13. (20 Minutes) (Determine selected consolidated balances)

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

Investment in Badger (value of debt and shares issued)	900,000	
Common Stock (par value)		150,000
Additional Paid-in Capital (excess over par value)		450,000
Liabilities		300,000

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

Professional services expense	30,000	
Additional Paid-in Capital	40,000	
Cash		70,000

Allocation of Acquisition-Date Excess Fair Value:

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

13. *(continued)*

Excess fair value (undervalued equipment)......................	**100,000**
Excess fair value (overvalued patented technology)	**(<u>20,000</u>)**
Goodwill..	**$<u>50,000</u>**

CONSOLIDATED BALANCES:

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

14. (50 Minutes) (Determine consolidated balances for a bargain purchase.) Prove those figures with a worksheet)

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

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

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

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

Investment in Tucker	**515,000**	
Long-Term Liabilities		**200,000**
Common Stock (par value)		**20,000**
Additional Paid-in Capital		**180,000**
Gain on Bargain Purchase.......................		**115,000**

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

14. ***(continued)***

Combination expenses	**30,000**	
Cash		**30,000**
(to record payment of combination fees)		
Additional Paid-in Capital	**12,000**	
Cash		**12,000**
(To record payment of stock issuance costs)		

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

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

Consideration transferred at fair value	**$400,000**
Book value (assets minus liabilities or total stockholders' equity)	**460,000**
Book value in excess of consideration transferred	**(60,000)**
Allocation to specific accounts based on fair value:	
Inventory...	**5,000**
Land	**20,000**
Buildings	**30,000**
Gain on bargain purchase (excess net asset fair value over consideration transferred)...................................	**$(115,000)**

CONSOLIDATED TOTALS

- **Cash = $38,000. Add the two book values less acquisition costs**
- **Receivables = $360,000. Add the two book values.**
- **Inventory = $505,000. Add the two book values plus the fair value adjustment**
- **Land = $400,000. Add the two book values plus the fair value adjustment.**
- **Buildings = $670,000. Add the two book values plus the fair value adjustment.**
- **Equipment = $210,000. Add the two book values.**
- **Total assets = $2,183,000. Summation of the above individual figures.**
- **Accounts payable = $190,000. Add the two book values.**
- **Long-term liabilities = $830,000. Add the two book values plus the debt incurred by the parent in acquiring the subsidiary.**
- **Common stock = $130,000.The parent's book value after stock issue to acquire the subsidiary.**
- **Additional paid-in capital = $528,000.The parent's book value after the stock issue to acquire the subsidiary less the stock issue costs.**
- **Retained earnings = $505,000. Parent company balance less $30,000 in combination expenses plus $115,000 gain on bargain purchase.**
- **Total liabilities and equity = $2,183,000. Summation of the above figures.**

14. *(continued)*

b. **MARSHALL COMPANY AND CONSOLIDATED SUBSIDIARY**

Worksheet

January 1, 2009

Accounts	*Marshall Company**	*Tucker Company*	*Consolidation Entries Debit*	*Consolidation Entries Credit*	*Consolidated Totals*
Debit Balances					
Cash..	18,000	20,000			38,000
Receivables	270,000	90,000			360,000
Inventory	360,000	140,000	(A) 5,000		505,000
Land	200,000	180,000	(A) 20,000		400,000
Buildings (net)	420,000	220,000	(A) 30,000		670,000
Equipment (net)	160,000	50,000			210,000
Investment in Tucker	515,000			(S) 460,000	
				(A) 55,000	-0-
Total debits	1,943,000	700,000			2,183,000
Credit Balances					
Accounts payable......................	150,000	40,000			190,000
Long-term liabilities	630,000	200,000			830,000
Common stock	130,000	120,000	(S) 120,000		130,000
Additional paid-in capital	528,000	-0-			528,000
Retained earnings, 1/1/09	505,000	340,000	(S) 340,000		505,000
Total credits..........................	1,943,000	700,000			2,183,000

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

15. (Prepare a consolidated balance sheet)

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

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

15. ***(continued)***

Pratt Company and Subsidiary
Consolidated Balance Sheet
December 31, 2009

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

16. (15 minutes) (Acquisition method entries for a merger)

Case 1:	Fair value of consideration transferred	$145,000
	Fair value of net identifiable assets	120,000
	Excess to goodwill	$25,000

Case 1 entry on Allerton's books:

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

Case 2: Bargain Purchase under acquisition method

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

Case 2 entry on Allerton's books:

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

Problem 16. (continued)

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

17. (25 minutes) (Combination entries—acquired entity dissolved)

a. Acquisition Method—Entry to record acquisition of Sampras

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

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

b. Purchase Method—Entry to record acquisition of Sampras

Purchase price (including direct combination costs)	$310,000
Fair value of net identifiable assets	282,000
Goodwill	$28,000

Receivables	80,000	
Inventory	70,000	
Buildings	115,000	
Equipment	25,000	
Customer list	22,000	
R&D expense	30,000	
Goodwill	28,000	
Current liabilities		10,000
Long-term liabilities		50,000
Cash		310,000

18. (30 Minutes) (Overview of the steps in applying the acquisition method when shares have been issued to create a combination. Part *h*. includes a bargain purchase.)

a. The fair value of the consideration includes

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

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

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

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

e.

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

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

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

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

Fair value of consideration transferred (above)		**$1,030,000**
Receivables	**$ 80,000**	
Patented technology	**700,000**	
Customer relationships	**500,000**	
IPR&D	**300,000**	
Liabilities	**(400,000)**	**1,180,000**
Gain on bargain purchase		**$ 150,000**

19. (50 Minutes) (Prepare balance sheet for a statutory merger using the acquisition method. Also, use worksheet to derive consolidated totals.)

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

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

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

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

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

Problem 19 (continued)

Post-Combination Balance Sheet:

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

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

Investment in On-the-Go Co	750,000	
Common Stock (NewTune, Inc., par value)		60,000
Additional Paid-in Capital		690,000
(To record acquisition of On-the-Go's shares)		
Additional Paid-in Capital	25,000	
Cash		25,000
(Stock issue costs incurred)		

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

19. (continued)

b.

NEWTUNE, INC., AND ON-THE-GO CO.
Consolidation Worksheet
January 1, 2009

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

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

The consolidation entries are designed to:

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

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

20. (40 minutes) (Prepare a consolidated balance sheet using the acquisition method).

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

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

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

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

b. and c.

	Pacifica	Seguros	Consolidation Entries		Consolidated Balance Sheet
Revenues	(1,200,000)				(1,200,000)
Expenses	890,000				890,000
Net income	(310,000)				(310,000)
Retained earnings, 1/1	(950,000)				(950,000)
Net income	(310,000)				(310,000)
Dividends paid	90,000				90,000
Retained earnings, 12/31	(1,170,000)				(1,170,000)
Cash	86,000	85,000			171,000
Receivables and inventory	750,000	190,000		(A) 10,000	930,000
Property, plant and equip.	1,400,000	450,000	(A)150,000		2,000,000
Investment in Seguros	1,062,500			(S) 705,000	0
				(A) 357,500	
Capitalized IPR&D			(A)100,000		100,000
Goodwill			(A) 77,500		77,500
Trademarks	300,000	160,000	(A) 40,000		500,000
Total assets	3,598,500	885,000			3,778,500
Liabilities	(500,000)	(180,000)			(680,000)
Contingent obligation	(62,500)				(62,500)
Common stock	(650,000)	(200,000)	(S) 200,000		(650,000)
Additional paid-in capital	(1,216,000)	(70,000)	(S) 70,000		(1,216,000)
Retained earnings	(1,170,000)	(435,000)	(S) 435,000		(1,170,000)
Total liabilities and equities	(3,598,500)	(885,000)			(3,778,500)

Answers to Purchase Method Problems

21. (30 Minutes) (Overview of the steps in applying the purchase method when shares have been issued to create a combination. Includes a bargain purchase.)

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

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

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

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

   e.

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

   The purchase price of $1,100,000 is thus allocated as follows:

Receivables	$ 80,000
Inventory	280,000
Land	400,000
Building	600,000
Goodwill	70,000
Liabilities	(330,000)
	$1,100,000

21. *(continued)*

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

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

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

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

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

Purchase price (above)................................		$ 800,000
Book value (above)		980,000
Book value in excess of purchase price.		$(180,000)
Allocations to specific accounts based on difference between fair value and book value:		
Inventory	$ 80,000	
Land	(200,000)	
Building	100,000	
Liabilities	70,000	50,000
Excess fair value over cost.....................		$(230,000)

21. *(continued)*

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

22. (10 Minutes) (Consolidated balances–*SFAS 141* purchase method)

a. Purchase price (fair value):

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

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

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

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

23. (10 Minutes) (Consolidated balances–*SFAS 141* purchase method)

a.

Purchase price: (includes combination costs)	$2,340,000
Book value of assets (no liabilities are indicated)	2,000,000
Cost in excess of book value	340,000
Excess cost assigned to Buildings account based on fair value	100,000
Goodwill	$240,000

23. ***(continued)***

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

c. **None of Winston's beginning retained earnings balance are included in consolidated figures as of the date of acquisition. As in Part b. (above), only the subsidiary's operational figures recognized after the February 1, 2009 purchase relate to the business combination.**

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

24. (20 Minutes) (Consolidated balances for a bargain purchase–*SFAS 141*)

a. **Inventory (fair value) $600,000**

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

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

Allocation of $60,000 Bargain Purchase:

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

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

24. *(continued)*

d. Buildings at fair value.. $1,000,000
Bargain purchase reduction (see b. above)..... (40,000)
Balance to be consolidated $960,000

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

25. (45 Minutes) (Purchase Method--Prepare entries for a statutory merger. Also, use worksheet to derive consolidated totals.)

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

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

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

25. a. *(continued)*

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

Cash	40,000	
Receivables	80,000	
Inventory	130,000	
Land	60,000	
Buildings	140,000	
Equipment	50,000	
Patent	30,000	
Goodwill	40,000	
Accounts Payable		30,000
Long-Term Liabilities		150,000
Cash		210,000
Common Stock (Merrill, Inc., par value)		100,000
Additional Paid-in Capital		80,000
(To record merger with Harriss at cost)		
Additional Paid-in Capital	6,000	
Cash		6,000
(Stock issue costs incurred)		

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

Investment in Harriss Co	380,000	
Cash		200,000
Common Stock (Merrill, Inc., par value)		100,000
Additional Paid-in Capital		80,000
(To record purchase of Harriss' shares)		
Investment in Harriss Co.	10,000	
Cash		10,000
(Direct combination costs incurred)		
Additional Paid-in Capital	6,000	
Cash		6,000
(Stock issue costs incurred)		

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

25. (continued)

b.

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

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

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

The consolidation entries are designed to:

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

Answers to Pooling Method Problems

26. B

27. (20 Minutes) (Asks for verbal discussion of the pooling of interests method)

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

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

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

28. (25 minutes) Pooling vs. purchase involving an unrecorded intangible

a.

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

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

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

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

Chapter 2 Develop Your Skills

FASB Research Case—Acquisition Method vs. Purchase Method

1. The acquisition method records a business combination at the fair value of the consideration transferred for the acquiree plus the fair value of any noncontrolling interest. Under the purchase method (SFAS 141), the business combination is measured at the accumulated cost of the combination.

2. In a business combination between willing parties in which the acquirer purchases 100 percent of the equity interests or net assets that constitute a business (an acquiree), the fair value of the consideration transferred usually is more clearly evident and reliably measurable than the fair value of the acquiree in the absence of evidence to the contrary. Therefore, the acquirer usually should use the acquisition-date fair value of the consideration transferred in exchange for the acquiree to measure the fair value of its share of the acquiree on that date. However, in cases where the fair value of the consideration transferred is not readily available, other estimation techniques may be used. These techniques include the market approach and the income approach.

3. If the net fair value of assets acquired and liabilities assumed exceeds the acquisition-date fair value of the acquired firm (consideration transferred plus noncontrolling interest fair value), the excess is recognized as a gain on bargain purchase. Thus, assets acquired and liabilities assumed are recognized at their fair values (with limited exceptions) even in a bargain purchase.

Under the *SFAS 141* purchase method, if the net fair value of assets acquired and liabilities assumed exceeds the cost of the combination, the excess first serves to reduce the fair values assigned to certain long-term assets with any remaining excess recognized as an extraordinary gain.

4. Contingent consideration obligates the acquirer to transfer additional assets or equity interests if specified future events occur or conditions are met. Contingent consideration can help to negotiate terms of a business combination when the parties differ in their estimates of future cash flows that the target will generate. Under the acquisition method the acquirer recognized the fair value of such contingent consideration as of the acquisition date and reports the obligation as either a liability or equity depending on the form of the obligation. Over time the contingency will either become more or less likely. Contingent consideration classified as equity will not be remeasured. Contingent consideration classified as liabilities will be measured at fair value with changes in the fair value recognized in income in each reporting period (unless otherwise required under SFAS 133 for derivative instruments).

5. This part of the assignment allows students individually to identify a specific aspect of a combination for further analysis. Further examples include costs of combination and in-process research and development.

Research and Analysis Case: PepsiCo–Quaker Oats Merger

1. **How was the merger between PepsiCo and Quaker Oats structured? Which firm is the survivor? Who holds what stock after the merger?**

   The merger between PepsiCo and Quaker Oats is structured as a stock for stock exchange. After the merger, Quaker Oats became a wholly owned subsidiary of PepsiCo. Quaker shareholders received PepsiCo's shares at the rate of 2.3:1 for each share of Quaker. So, technically, a "continuity of ownership interests" for the Quaker shareholders exists in this combination, even though the Quaker shareholders will own only 18% of the combined firm.

2. **What accounting method was used to account for the merger of PepsiCo and Quaker Oats? What are the reporting implications of the chosen accounting method?**

   The pooling-of-interests method was used to account for the merger. The reporting implications of pooling-of-interests accounting are:
   - **Assets and liabilities of subsidiary continue to be reported at book value**
   - **Revenues and expenses of subsidiary are recognized retroactively**
   - **Shares issued to create business combination is recorded based on the book value of subsidiary's contributed capital and retained earnings at the beginning of year**
   - **Combination costs are expensed as incurred**

3. **What were the approximate amounts for the**
   a. **recorded value of the acquisition of the surviving firm's books?**
      613 million
   b. **Market value of the acquisition?**
      13 billion ($42 × 306 million).

4. **What items of value did Quaker Oats bring to the merger that will not be recorded in the acquisition? How will these items affect future reported income for the combined firm?**

   Quaker Oats brought to the merger its trademark, some internally developed intangibles, goodwill and IPR&D, etc. These items will contribute to the reported income for the combined firm. After the acquisition, PepsiCo expects $400 million in annual savings from synergies from the merger.

5. **Evaluate the financial reporting for the PepsiCo acquisition of Quaker Oats. Be sure to state explicitly your selected criteria for evaluation.**

The pooling of interests method impedes several necessary and important accounting characteristics: representational faithfulness, neutrality, and comparability.

First, since PepsiCo recorded all the assets and liabilities acquired from Quaker Oats based on its book value, financial statement users cannot tell how much was invested in the transaction nor track the subsequent performance of the investment. So both the predictive value and feedback value of the financial information about the acquisition are impaired.

Second, the internally developed intangibles may go entirely unrecorded under the pooling of interests. At the same time, the potential financial benefits from the synergy of the business combination won't be recognized either. Since these two items may be recognized under the purchase method, representational faithfulness is impaired here.

Because pooling of interests may boost earnings of the combined entity and accordingly, make the combined entity appear more profitable than a similar entity that employs the purchase method, the neutrality of accounting information is impaired. In particular, those firms who could afford to meet all 16 criteria under APB #18 were better able to artificially improve their earnings reports.

In addition, comparability is impeded because the financial statement users can't compare the post-acquisition performance of PepsiCo with that of other competitive companies that used the purchase method to account for their business combination.

***Research and Analysis Cases 2 through 4 and the Communication Case* require student specific responses. Thus, we do not provide solutions to these cases.**