

INTRODUCTION TO BUSINESS COMBINATIONS AND THE CONCEPTUAL FRAMEWORK

LEARNING OBJECTIVES

- 1 Describe historical trends in types of business combinations.
- 2 Identify the major reasons firms combine.
- 3 Identify the factors that managers should consider in exercising due diligence in business combinations.
- 4 Identify defensive tactics used to attempt to block business combinations.
- 5 Distinguish between an asset and a stock acquisition.
- 6 Indicate the factors used to determine the price and the method of payment for a business combination.
- 7 Calculate an estimate of the value of goodwill to be included in an offering price by discounting expected future excess earnings over some period of years.
- 8 Describe the two alternative views of consolidated financial statements: the economic entity and the parent company concepts.
- 9 List and discuss each of the *Statements of Financial Accounting Concepts (SFAC)* that remain in effect.
- 10 Describe some of the current joint projects of the FASB and the International Accounting Standards Board (IASB), and their primary objectives.

You can hardly pick up a copy of the *Wall Street Journal* without reading about an acquisition or a merger. These events are widely important because so many individuals and entities have vested interests.

Consider the recent announcement by AT&T to acquire T-Mobile. Shareholders of each company are concerned about the stock price reaction and the amount of consideration offered in the deal. AT&T's stock price increased almost 6% while Deutsche Telekom's (parent company to T-Mobile USA) increased more than 12%. Current and prospective shareholders are obviously interested in the future performance of the merged company. Since there are numerous stories about failed mergers, analysts are constantly examining both companies to determine if the merged firm is a "good fit." Initial reaction is that both companies use GSM technology and plan to use the new LTE technology in the future. Thus there appear to be significant technology synergies between the two companies. Employees of both companies express concern about the merger because the announcement claimed a potential savings of \$40 billion in costs (likely to include thousands of job cuts).

Customers of each company wonder what will happen to the prices that they pay for services if consummated. This merger would reduce the number of major wireless carriers from four to three. However, before the deal is final, both the Federal Communications Commission (FCC) and the Department of Justice must approve the merger. This process can take over a year. These regulatory bodies have expressed concern over the lack of competition in the wireless market. Specifically, the FCC believes that the industry is too concentrated, noting that 60% of the nation's subscribers and revenue come from the country's two largest wireless providers (AT&T and Verizon) while other companies have been losing subscribers. Suppliers of phone handsets are also very interested in the announcement. For instance, Motorola supplied GSM-based phones to both AT&T and T-Mobile. If the merger is approved, Motorola will be dealing with a single buyer. This might put Motorola at a disadvantage in terms of setting prices and determining the types of phones to offer. Thus the impact of an acquisition is far reaching and affects many different companies and individuals. The objective of the first section of this textbook is to introduce and illustrate fully the guidelines for accounting for mergers and acquisitions.

Growth through mergers and acquisitions (M&A) has become a standard in business not only in America but throughout the world. In the new millennium, the most recent in a series of booms in merger activity was sparked by cheaper credit and by global competition, in addition to the usual growth-related incentives predominant during the boom of the 1990s. By the end of 2008, however, uncertainty in the commercial credit markets had led to anxiety about whether merger transactions could continue to be achieved successfully in the current environment, and by the middle of 2009 M&A activity had nearly come to a halt. With plunging market values and tightened credit, the mix and nature of the financing components were clearly in flux, and major adaptations needed to consummate any new deals.

As the markets began to recover in the second half of 2009, however, merger transactions picked up once more. Banks made capital available for bigger companies, such as Kraft, who looked to acquire Cadbury, and corporate debt offerings soared. By 2010, several huge deals were in the works.

Merger activity seems to be highly correlated with the movement of the stock market. Increased stock valuation increases a firm's ability to use its shares to acquire other companies and is often more appealing than issuing debt. During the merger cycle of the 1990s, equity values fueled the merger wave. The slowing of merger activity in the early years of the 21st century provided a dramatic contrast to this preceding period. Beginning with the merger of Morgan Stanley and Dean Witter Discover and ending with the biggest acquisition to that date—WorldCom's bid for MCI—the year 1997 marked the third consecutive year of record mergers and acquisitions activity.¹ The pace accelerated still further in 1998 with unprecedented merger activity in the banking industry, the auto industry, financial services, and telecommunications, among others. This activity left experts wondering why and whether bigger was truly better. It also left consumers asking what the impact would be on service. A wave of stock swaps was undoubtedly sparked by record highs in the stock market, and stockholders reaped benefits from the mergers in many cases, at least in the short run. Regulators voiced concern about the dampening of competition, and consumers were quick to wonder where the

¹ *WSJ Europe*, "U.S. Merger Activity Marks New Record," by Steven Lipin, 1/2/98, p. R9.

real benefits lay. Following the accounting scandals of 2001 (WorldCom, Enron, Tyco, etc.), merger activity lulled for a few years.

Also in 2001, the *Financial Accounting Standards Board (FASB)* voted in two major accounting changes related to business combinations. The first met with vehement protests that economic activity would be further slowed as a result and the second with excitement that it might instead be spurred. Both changes are detailed in Chapter 2.

By the middle of 2002, however, these hopes had been temporarily quelled. Instead of increased earnings, many firms active in mergers during the 1990s were forced to report large charges related to the diminished value of long-lived assets (mainly goodwill). Merger activity slumped, suggesting that the frenzy had run its course. Market reaction to the mergers that did occur during this period typified the market's doubts. When *Northrop Grumman Corp.* announced the acquisition of *TRW Inc.* for \$7.8 billion, the deal was praised but no market reaction was noted. In contrast, when Vivendi Universal admitted merger-gone-wrong woes, investors scurried.

By the middle of the first decade of the 21st century, however, the frenzy was returning with steady growth in merger activity from 2003 to 2006. In 2005, almost 18% of all M&A (mergers & acquisitions) deals were in the services sector. In a one-week period in June of 2006, \$100 billion of acquisitions occurred, including Phelps Dodge's \$35.4 billion acquisition of Inco Ltd. and Falconbridge Ltd. In addition, because of the economic rise in China and India, companies there were looking to increase their global foothold and began acquiring European companies. Thus cross-border deals within Europe accounted for a third of the global M&A deals.

However, by the end of 2008, a decline in overall merger activity was apparent as the U.S. economy slid into a recession, and some forecasters were predicting the next chapter in mergers and acquisitions to center around bankruptcy-related activity. Data from Thomson Reuters revealed that in 2008, bankruptcy-related merger activity increased for the first time in the last six years. For example, the number of Chapter 11 M&A purchases rose from 136 for the entire year of 2007 to 167 for the first ten months of 2008, with more to come. Overall mergers, on the other hand, decreased from \$87 billion in the United States (\$277 billion globally) during October 2007 to \$78 billion in the United States (\$259 billion globally) during October 2008, based on the Reuters data.

On December 4, 2007, FASB released two new standards, *FASB Statement No. 141 R, Business Combinations*, and *FASB Statement No. 160, Noncontrolling Interests in Consolidated Financial Statements [ASC 805, "Business Combinations" and ASC 810, "Consolidations,"* based on FASB's new codification system]. These standards have altered the accounting for business combinations dramatically.

Both statements became effective for years *beginning after December 15, 2008*, and are intended to improve the relevance, comparability and transparency of financial information related to business combinations, and to facilitate the convergence with international standards. They represent the completion of the first major joint project of the FASB and the IASB (International Accounting Standards Board), according to one FASB member, G. Michael Crooch. The FASB also believes the new standards will reduce the complexity of accounting for business combinations. These standards are integrated throughout this text.

IN
THE
NEWS

"If we are going to ride the IASB and the IFRS [International Financial Reporting Standards] horse, we want to make sure that it's as good as it can be. We want to make sure that the IASB is strong, is independent, is well resourced, and is properly funded in a broad-based and secure way."²

IFRS

PLANNING M&A IN A CHANGING ENVIRONMENT AND UNDER CHANGING ACCOUNTING REQUIREMENTS

1. The timing of deals is critical. The number of days between agreement or announcement and deal consummation can make a huge difference.
2. The effects on reporting may cause surprises. More purchases qualify as business combinations than previously. Income tax provisions can trigger disclosures.
3. Assembling the needed skill and establishing the needed controls takes time. The use of fair values is expanded, and more items will need remeasurement or monitoring after the deal.
4. The impact on earnings in the year of acquisition and subsequent years will differ from that in past mergers, as will the effects on earnings of step purchases or sales.
5. Unforeseen effects on debt covenants or other legal arrangements may be lurking in the background, as a result of the changes in key financial ratios.³

IN
THE
NEWS

"By 2006, the percentage of the mergers and acquisitions market accounted for by private-equity firms had increased to approximately 15 percent from around 4 percent in 1990."⁴

IN
THE
NEWS

In part due to demand for energy assets, as well as easy access to capital and a record amount of private equity fund raising, merger and acquisition volume worldwide soared to over \$2.7 trillion in 2005, marking a 38.4% increase from 2004 (which was previously the best year for M&A since 2000 and one of the best years ever for deal making). In the U.S., M&A volume rose 33.3% to more than \$1.1 trillion from \$848.7 billion in 2004. These results mark the first time U.S. M&A proceeds exceeded the trillion dollar mark since 2000.⁵

Growth is a major objective of many business organizations. Top management often lists growth or expansion as one of its primary goals. A company may grow slowly, gradually expanding its product lines, facilities, or services, or it may skyrocket almost overnight. Some managers consider growth so important that they say their companies

² "Change Agent: Robert Hertz discusses FASB's priorities, the road to convergence and changes ahead for CPAs," *Journal of Accountancy*, February 2008, p. 31.

³ BDO Seidman, LLP, "Client Advisory," No. 2008-1, January 31, 2008.

⁴ *The New York Post*, "Money to Burn," by Suzanne Kapner, March 28, 2006, p. 33.

⁵ Thompson Financial, "Fourth Quarter 2005 Mergers & Acquisitions Review."

must “grow or die.” In the past hundred years, many U.S. businesses have achieved their goal of expansion through business combinations. A **business combination** occurs when *the operations of two or more companies are brought under common control.*



IN
THE
NEWS

AT&T Corporation announced its intentions to buy BellSouth Corporation for \$67 billion. This action was a direct result of increased competition against low-cost rivals in the phone, wireless, and television markets. This is considered an interesting move because if approved, it would reunite another of the Baby Bells with AT&T. AT&T was required to spin off its local exchange service operating units in 1982. At that time, seven companies were created, and these companies were known as the Baby Bells. Since then, AT&T has reacquired three of the Baby Bells, and BellSouth would be the fourth Baby Bell acquired. Only two other Baby Bells remain at this time: Qwest and Verizon. The merger ranks as one of the dozen largest deals ever.⁶

NATURE OF THE COMBINATION

A business combination may be friendly or unfriendly. In a **friendly combination**, *the boards of directors of the potential combining companies negotiate mutually agreeable terms of a proposed combination.* The proposal is then submitted to the stockholders of the involved companies for approval. Normally, a two-thirds or three-fourths positive vote is required by corporate bylaws to bind all stockholders to the combination.

An **unfriendly (hostile) combination** results when *the board of directors of a company targeted for acquisition resists the combination.* A formal **tender offer** enables the acquiring firm to deal directly with individual shareholders. The tender offer, usually published in a newspaper, typically provides a price higher than the current market price for shares made available by a certain date. If a sufficient number of shares are not made available, the acquiring firm may reserve the right to withdraw the offer. Because they are relatively quick and easily executed (often in about a month), tender offers are the preferred means of acquiring public companies.



IN
THE
NEWS

BASF AG, the transnational chemical company based in Germany, will file an unsolicited \$4.9 billion takeover bid for Engelhard Corp., the New Jersey-based specialty chemicals maker. The disclosure of BASF's all-cash tender offer for Engelhard comes as it tries to become a market leader in the fast-expanding catalyst industry. If successful, the tender would represent the biggest German hostile takeover of a U.S. corporation and BASF's largest acquisition ever.⁷

Although tender offers are the preferred method for presenting hostile bids, most tender offers are friendly ones, done with the support of the target company's management. Nonetheless, hostile takeovers have become sufficiently common that a number of mechanisms have emerged to resist takeover.

⁶ *The New York Times*, "Huge Phone Deal Seeks to Thwart Smaller Rivals," by Ken Belson, 3/6/06, p. A1.

⁷ *WSJ*, "BASF Aims to Bulk Up Globally," by Mike Esterl, 1/5/06, p. A14.



IN
THE
NEWS

A friendly bid by Germany's Bayer AG for fellow German drug maker Schering AG tops a hostile bid by Merck KGaA and could create a pharmaceutical behemoth capable of competing with U.S. and European rivals. Schering's executive board backed Bayer's €16.34 billion (\$19.73 billion) offer, making it unlikely another bidder will emerge. If approved by Schering's shareholders, the two companies plan to combine their prescription drug businesses into a new firm called Bayer-Schering Pharmaceuticals with anticipated sales of more than €9 billion a year and headquarters in Berlin. Revenue of the new company would exceed that of Schering-Plough Corp. of the U.S., which is unrelated to the German Schering.⁸

Defense Tactics

Resistance often involves various moves by the target company, generally with colorful terms. Whether such defenses are ultimately beneficial to shareholders remains a controversial issue. Academic research examining the price reaction to defensive actions has produced mixed results, suggesting that the defenses are good for stockholders in some cases and bad in others. For example, when the defensive moves result in the bidder (or another bidder) offering an amount higher than initially offered, the stockholders benefit. But when an offer of \$40 a share is avoided and the target firm remains independent with a price of \$30, there is less evidence that the shareholders have benefited.

A certain amount of controversy surrounds the effectiveness, as well as the ultimate benefits, of the following defensive moves:

LO4 Defensive tactics are used.

1. **Poison pill:** Issuing stock rights to existing shareholders enabling them to purchase additional shares at a price below market value, but exercisable only in the event of a potential takeover. This tactic has been effective in some instances, but bidders may take managers to court and eliminate the defense. In other instances the original shareholders benefit from the tactic. Chrysler Corp. announced that it was extending a poison pill plan until February 23, 2008, under which the rights become exercisable if anyone announces a tender offer for 15% or more, or acquires 15%, of Chrysler's outstanding common shares. Poison pills are rarely triggered, but their existence serves as a preventative measure.



IN
THE
NEWS

In its attempt to ward off investors calling for new management, health-club operator Bally Total Fitness Holding Corp. stated that its two largest shareholders may be conspiring, which could trigger the company's poison pill and effectively reduce the investors' ownership stakes. The shareholders, Liberation Investments and Pardus Capital Management, have called for new members on Bally's board and the firing of CEO Paul Toback. The Chicago-based company said it was considering petitioning a court to determine whether its shareholder-rights plan was triggered as a result of Liberation and Pardus acting together.⁹

⁸ WSJ, "Bayer Joins Race to Build German Drug Titan," by Jeanne Whalen, Jason Singer, and Mike Esterl, 3/24/06, p. A3.

⁹ WSJ, "Bally Examines Poison Pill Move to Fight Pressures," Reuters News Service, 12/27/05, p. A6.

2. *Greenmail*: The purchase of any shares held by the would-be acquiring company at a price substantially in excess of their fair value. The purchased shares are then held as treasury stock or retired. This tactic is largely ineffective because it may result in an expensive excise tax; further, from an accounting perspective, the excess of the price paid over the market price is expensed.
3. *White knight or white squire*: Encouraging a third firm more acceptable to the target company management to acquire or merge with the target company.
4. *Pac-man defense*: Attempting an unfriendly takeover of the would-be acquiring company.
5. *Selling the crown jewels*: The sale of valuable assets to others to make the firm less attractive to the would-be acquirer. The negative aspect is that the firm, if it survives, is left without some important assets.
6. *Leveraged buyouts*: The purchase of a controlling interest in the target firm by its managers and third-party investors, who usually incur substantial debt in the process and subsequently take the firm private. The bonds issued often take the form of high-interest, high-risk “junk” bonds. Leveraged buyouts will be discussed in more detail in Chapter 2.

BUSINESS COMBINATIONS: WHY? WHY NOT?

LO2 Reasons firms combine.

A company may expand in several ways. Some firms concentrate on **internal** expansion. A firm may expand internally by engaging in product research and development. Hewlett-Packard is an example of a company that relied for many years on new product development to maintain and expand its market share. A firm may choose instead to emphasize marketing and promotional activities to obtain a greater share of a given market. Although such efforts usually do not expand the total market, they may redistribute that market by increasing the company's share of it.

For other firms, **external** expansion is the goal; that is, they try to expand by acquiring one or more other firms. This form of expansion, aimed at producing relatively rapid growth, has exploded in frequency and magnitude in recent years. A company may achieve significant cost savings as a result of external expansion, perhaps by acquiring one of its major suppliers.

In addition to rapid expansion, the business combination method, or external expansion, has several other potential advantages over internal expansion:

1. *Operating synergies* may take a variety of forms. Whether the merger is **vertical** (a merger between a supplier and a customer) or **horizontal** (a merger between competitors), combination with an existing company provides management of the acquiring company with an established operating unit with its own experienced personnel, regular suppliers, productive facilities, and distribution channels. In the case of vertical mergers, synergies may result from the elimination of certain costs related to negotiation, bargaining, and coordination between the parties. In the case of a horizontal merger, potential synergies include the combination of sales forces, facilities, outlets, and so on, and the elimination of unnecessary duplication in costs. When a private company is acquired, a plus may be the potential to eliminate not only duplication in costs but also unnecessary costs.


 IN
THE
NEWS

Chiron Corp. agreed to be acquired by Novartis AG for \$45 per share, or \$5.1 billion. Swiss pharmaceutical giant Novartis already owned 42% of Chiron, the biotechnology pioneer. Novartis's reason for acquiring Chiron is the fast-growing flu vaccine market, Chiron's focus, as well as its production of other inoculations for meningitis and polio. Novartis predicts that the market for all vaccines worldwide will more than double from \$9.6 billion in 2004 to in excess of \$20 billion in 2009 as prevention becomes a bigger element of healthcare.¹⁰

Management of the acquiring company can draw upon the operating history and the related historical database of the acquired company for planning purposes. A history of profitable operations by the acquired company may, of course, greatly reduce the risk involved in the new undertaking. A careful examination of the acquired company's expenses may reveal both expected and unexpected costs that can be eliminated. On the more negative (or cautious) side, be aware that the term "synergies" is sometimes used loosely. If there are truly expenses that can be eliminated, services that can be combined, and excess capacity that can be reduced, the merger is more likely to prove successful than if it is based on growth and "so-called synergies," suggests Michael Jensen, a professor of finance at the Harvard Business School.


 IN
THE
NEWS

Views on whether synergies are real or simply a plug figure to justify a merger that shouldn't happen are diverse. Time Warner, for example, has fluctuated back and forth on this issue in recent years. President Jeffrey Bewkes recently was quoted as saying, "No division should subsidize another." When queried about the message his predecessors sent to shareholders, he said, "It's bull—"¹¹

GAINS FROM BULKING UP¹²

| <i>Industry</i> | <i>Key Benefit of Consolidation</i> |
|---------------------------|--|
| Antenna towers | Frees up capital and management time for wireless communications operators |
| Funeral homes | Yields greater discounts on coffins, supplies, and equipment |
| Health clubs | Spreads regional marketing and advertising costs over more facilities |
| Landfill sites | Lets operators cope with the new environmental and regulatory demands |
| Physician group practices | Reduces overhead and costs of medical procedures |

- Combination may enable a company to compete more effectively in the **international marketplace**. For example, an acquiring firm may diversify its operations

¹⁰ *WSJ*, "Novartis Agrees to Acquire the Rest of Chiron for \$5.1 Billion," by David P. Hamilton, 11/1/05, p. A6.

¹¹ *WSJ*, "After Years of Pushing Synergy, Time Warner Inc. Says Enough," by Matthew Karnitschnig, 6/2/06, p. A1.

¹² *Business Week*, "Buy 'Em Out, Then Build 'Em Up," by Eric Schine, 5/18/95, p. 84.

rather rapidly by entering new markets; alternatively, it may need to ensure its sources of supply or market outlets. Entry into new markets may also be undertaken to obtain cost savings realized by smoothing cyclical operations. Diminishing savings from cost-cutting *within* individual companies makes combination more appealing. The financial crisis in Asia accelerated the pace for a time as American and European multinationals competed for a shrinking Asian market. However, a combination of growing competition, globalization, deregulation, and financial engineering has led to increasingly complex companies and elusive profits.

3. Business combinations are sometimes entered into to take advantage of **income tax laws**. The opportunity to file a consolidated tax return may allow profitable corporations' tax liabilities to be reduced by the losses of unprofitable affiliates. When an acquisition is financed using debt, the interest payments are tax deductible, creating a **financial synergy** or "tax gain." Many combinations in the past were planned to obtain the advantage of significant operating loss carryforwards that could be utilized by the acquiring company. However, the Tax Reform Act of 1986 limited the use of operating loss carryforwards in merged companies. Because tax laws vary from year to year and from country to country, it is difficult to do justice to the importance of tax effects within the scope of this chapter. Nonetheless, it is important to note that tax implications are often a driving force in merger decisions.
4. **Diversification** resulting from a merger offers a number of advantages, including increased flexibility, an internal capital market, an increase in the firm's debt capacity, more protection from competitors over proprietary information, and sometimes a more effective utilization of the organization's resources. In debating the tradeoffs between diversification and focusing on one (or a few) specialties, there are no obvious answers.



More than a third of bankruptcy merger activity in 2008 took place in financial services, with the sale of assets by Lehman Brothers (New York investment bank) and the \$2.8 billion acquisition by a consortium of Ashikaga Bank (Japan). Others included Thornwood Associates' \$900 million purchase of Federal-Mogul, Mendecino Redwood's \$600 million acquisition of Pacific Lumber, and NBTY's \$371 million purchase of Leiner Health Products.¹³

5. **Divestitures** accounted for 30% or more of the merger and acquisitions activity in each quarter from 1995 into mid-1998 and from 2001 to 2010. Shedding divisions that are not part of a company's core business became common during this period. In some cases the divestitures may be viewed as "undoing" or "redoing" past acquisitions. A popular alternative to selling off a division is to "spin off" a unit. Examples include AT&T's spin-off of its equipment business to form *Lucent Technologies Inc.*, Sears Roebuck's spin-off of *Allstate Corp.* and *Dean Witter Discover & Co.*, and Cincinnati Bell's proposed spin-off of its billing and customer-management businesses to form *Convergys Corp.*

¹³ "Water Cooler: What Players in the Mid Market Are Talking About," *Mergers & Acquisitions*, December 2008.


 IN
THE
NEWS

As Verizon Communications seeks to focus more on its wireless business and high-growth areas such as Internet services and television, the company said it plans to shed its phone directories business in a transaction that could be valued at more than \$17 billion. The divestiture should lighten Verizon's debt load, an essential step as it moves forward with a \$20 billion effort to replace its copper network with fiber-optic strands and starts offering television to subscribers.¹⁴

Notwithstanding its apparent advantages, business combination may not always be the best means of expansion. An overriding emphasis on rapid growth may result in the pyramiding of one company on another without sufficient management control over the resulting conglomerate. Too often in such cases, management fails to maintain a sound enough financial equity base to sustain the company during periods of recession. Unsuccessful or incompatible combinations may lead to future divestitures.

In order to avoid large dilutions of equity, some companies have relied on the use of various debt and preferred stock instruments to finance expansion, only to find themselves unable to provide the required debt service during a period of decreasing economic activity. The junk bond market used to finance many of the mergers in the 1980s had essentially collapsed by the end of that decade.

Business combinations may destroy, rather than create, value in some instances. For example, if the merged firm's managers transfer resources to subsidize money-losing segments instead of shutting them down, the result will be a suboptimal allocation of capital. This situation may arise because of reluctance to eliminate jobs or to acknowledge a past mistake.

Some critics of the accounting methods used in the United States prior to 2002 to account for business combinations argued that one of the methods did not hold executives accountable for their actions if the price they paid was too high, thus encouraging firms to "pay too much." Although opinions are divided over the relative merits of the accounting alternatives, most will agree that the resulting financial statements should reflect the economics of the business combination. Furthermore, if and when the accounting standards and the resulting statements fail even partially at this objective, it is crucial that the users of financial data be able to identify the deficiencies. Thus we urge the reader to keep in mind that an important reason for learning and understanding the details of accounting for business combinations is to understand the economics of the business combination, which in turn requires understanding any possible deficiencies in the accounting presentation.

BUSINESS COMBINATIONS: HISTORICAL PERSPECTIVE

LQ1 Historical trends in types of M&A.

In the United States there have been three fairly distinct periods characterized by many business mergers, consolidations, and other forms of combinations: 1880–1904, 1905–1930, and 1945–present. During the first period, huge holding companies, or trusts, were created by investment bankers seeking to establish monopoly control over certain industries. This type of combination is generally called **horizontal integration** because it involves the combination of companies within the same industry. Examples of the trusts formed during this period are J. P. Morgan's U.S. Steel Corporation and

¹⁴ WSJ, by Ionne Searcy, Dennis K. Berman, and Almar Latour, 12/5/05, p. A3.

other giant firms such as Standard Oil, the American Sugar Refining Company, and the American Tobacco Company. By 1904, more than 300 such trusts had been formed, and they controlled more than 40% of the nation's industrial capital.

The second period of business combination activity, fostered by the federal government during World War I, continued through the 1920s. In an effort to bolster the war effort, the government encouraged business combinations to obtain greater standardization of materials and parts and to discourage price competition. After the war, it was difficult to reverse this trend, and business combinations continued. These combinations were efforts to obtain better integration of operations, reduce costs, and improve competitive positions rather than attempts to establish monopoly control over an industry. This type of combination is called **vertical integration** because it involves the combination of a company with its suppliers or customers. For example, Ford Motor Company expanded by acquiring a glass company, rubber plantations, a cement plant, a steel mill, and other businesses that supplied its automobile manufacturing business. From 1925 to 1930, more than 1,200 combinations took place, and about 7,000 companies disappeared in the process.

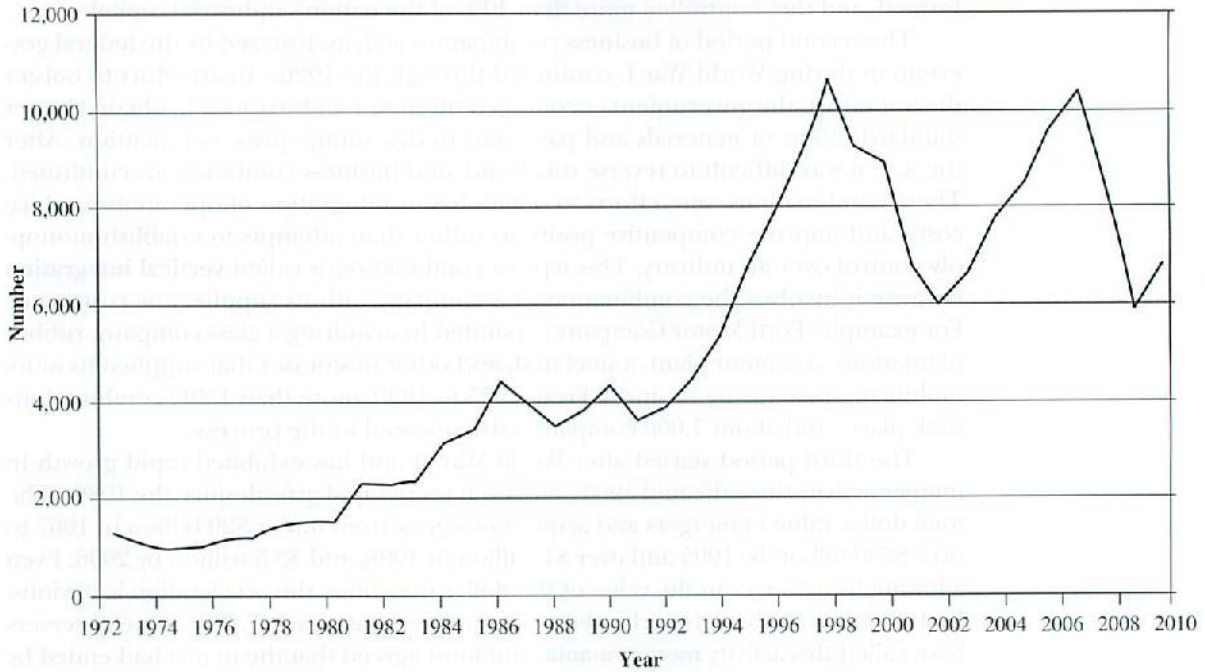
The third period started after World War II and has exhibited rapid growth in merger activity since the mid-1960s, and even more rapid growth since the 1980s. The total dollar value of mergers and acquisitions grew from under \$20 billion in 1967 to over \$300 billion by 1995 and over \$1 trillion in 1998, and \$3.5 trillion by 2006. Even allowing for changes in the value of the dollar over time, the acceleration is obvious. By 1996, the number of yearly mergers completed was nearly 7,000. Some observers have called this activity **merger mania**, and most agreed that the mania had ended by mid-2002. However, by 2006, merger activity was soaring once more. Illustration 1-1 presents two rough graphs of the level of merger activity for acquisitions over \$10 million from 1972 to 2010 in number of deals, and from 1979 to 2010 in dollar volume. Illustration 1-2 presents summary statistics on the level of activity for the year 2010 by industry sector for acquisitions with purchase prices valued in excess of \$10 million.

This most recent period can be further subdivided to focus on trends of particular decades or subperiods. For example, many of the mergers that occurred in the United States from the 1950s through the 1970s were **conglomerate** mergers. Here the primary motivation for combination was often to diversify business risk by combining companies in different industries having little, if any, production or market similarities, or possibly to create value by lowering the firm's cost of capital. One conjecture for the popularity of this type of merger during this time period was the strictness of regulators in limiting combinations of firms in the same industry. One conglomerate may acquire another, as Esmark did when it acquired Norton-Simon, and conglomerates may spin off, or divest themselves of, individual businesses. Management of the conglomerate hopes to smooth earnings over time by counterbalancing the effects of economic forces that affect different industries at different times.

In contrast, the 1980s were characterized by a relaxation in antitrust enforcement during the Reagan administration and by the emergence of high-yield junk bonds to finance acquisitions. The dominant type of acquisition during this period and into the 1990s was the **strategic acquisition**, claiming to benefit from **operating synergies**. These synergies may arise when the talents or strengths of one of the firms complement the products or needs of the other, or they may arise simply because the firms were former competitors. An argument can be made that the dominant form of acquisition shifted in the 1980s because many of the conglomerate mergers of the 1960s and 1970s proved unsuccessful; in fact, some of the takeovers of the 1980s were of a disciplinary nature, intended to break up conglomerates.

ILLUSTRATION 1-1 PART A

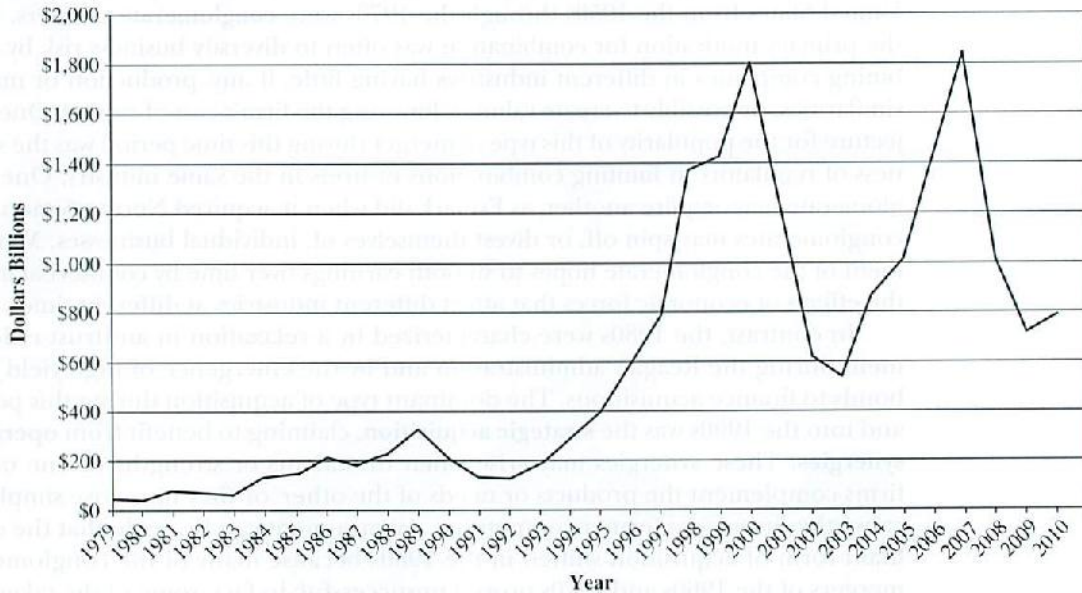
Number of Mergers and Acquisitions over \$10 Million 1972 to 2010



Adapted from *Mergers and Acquisitions*, February 2002, 2004, 2006, 2009, 2010, March/April 1999, May/June 1989.

ILLUSTRATION 1-1 PART B

Value of Mergers and Acquisitions over \$10 Million 1979 to 2010



Adapted from *Mergers & Acquisitions*, February 2010, 2009, 2006, 2004, 2002.

ILLUSTRATION 1-2

10 Most Active Industries by Number of Transactions in 2010

| Rank | Industry | Number of Deals | % of All M&A Deals |
|----------|---|-----------------|--------------------|
| 1 | Business Services | 1,329 | 19.5% |
| 2 | Software | 577 | 8.5% |
| 3 | Health Services | 276 | 4.1% |
| 4 | Real Estate | 267 | 3.9% |
| 5 | Oil & Gas | 261 | 3.8% |
| 6 | Investment & Commodity Firms | 242 | 3.6% |
| 7 | Commercial Banks | 227 | 3.3% |
| 8 | Measuring, Medical & Photographic Equipment | 206 | 3.0% |
| 9 | Electronic and Electrical Equipment | 180 | 2.6% |
| 10 (tie) | Utilities Distribution | 171 | 2.5% |
| 10 (tie) | Insurance | 171 | 2.5% |

10 Most Active Industries by Dollar Volume in 2010

| Rank | Industry | Value (\$ billions) | % of Total M&A Value |
|------|---|---------------------|----------------------|
| 1 | Oil & Gas | 111.5 | 14.2% |
| 2 | Food & Kindred Products | 72.5 | 9.2% |
| 3 | Business Services | 64.7 | 8.2% |
| 4 | Utilities Distribution | 54.3 | 6.9% |
| 5 | Drugs (Pharmaceuticals?) | 43.4 | 5.5% |
| 6 | Transportation & Shipping (Except Air) | 41.6 | 5.3% |
| 7 | Investment & Commodity Firms | 31.0 | 3.9% |
| 8 | Software | 27.6 | 3.5% |
| 9 | Insurance | 27.1 | 3.4% |
| 10 | Measuring, Medical & Photographic Equipment | 25.8 | 3.3% |

Adapted from *Mergers & Acquisitions*, February 2010.

Deregulation undoubtedly played a role in the popularity of combinations in the 1990s. In industries that were once fragmented because concentration was forbidden, the pace of mergers picked up significantly in the presence of deregulation. These industries include banking, telecommunications, and broadcasting. Although recent years have witnessed few deals blocked due to antitrust enforcement, an example of a major transaction dropped in 1996 because of a planned FTC (Federal Trade Commission) challenge was in the drugstore industry. The FTC challenged the impact of a proposed merger between *Rite Aid Corp.* and *Revco D.S. Inc.* on market power in several sectors of the East and Midwest. Nonetheless, subsequent deals in the industry saw both companies involved: Rite Aid acquired *Thrifty PayLess Holdings Inc.*, and *CVS Inc.* purchased Revco in February 1997.

Later, the Justice Department sued to block Primestar's acquisition of a satellite slot owned by *MCI* and *News Corp.* The department claimed the deal would thwart competition by giving the companies the last direct competition to cable: a direct-broadcast satellite service using 18-inch dish receivers.¹⁵ Other deals were dropped

¹⁵ *WSJ*, "Antitrust Suit Filed to Block Primestar Purchase," by John Wilke, 5/13/98, p. A3 (Eastern Edition).

in the face of possible intervention, including a planned merger between CPA firms KPMG Peat Marwick and Ernst & Young in 1998, although other factors undoubtedly played a role as well. Nonetheless, over time the group of large CPA firms once referred to as the Big 8 has blended into the Big 4, raising concerns about a possible lack of competition in the audit market for large companies.



IN
THE
NEWS

Before the announcement of the merger between AT&T and T-Mobile, phone handset makers such as HTC and Motorola had two major carriers (ATT and T-Mobile) who could buy their GSM-based phones. They just lost any ability to control price and profits on handsets because now there is a single buyer that can dictate what GSM phones come to market. Even with LTE becoming the standard for the 4G world, it would essentially be a market dominated by three buyers (should Sprint go with LTE), which would place handset makers at the mercy of the giants.¹⁶



IN
THE
NEWS

Virtually every deal in the 2010 Wall Street lineup of potential mega-mergers faced regulatory challenges both in the United States and in Europe. Examples include Oracle and Sun; Exxon and XTO Energy; Yahoo and Microsoft, Kraft and Cadbury.

TERMINOLOGY AND TYPES OF COMBINATIONS

LO 5 Stock versus asset acquisitions.

From an accounting perspective, the distinction that is most important at this stage is between an **asset acquisition** and a **stock acquisition**. In Chapter 2, we focus on the acquisition of the assets of the acquired company, where only the acquiring or new company survives. Thus the books of the acquired company are closed out, and its assets and liabilities are transferred to the books of the acquirer. In subsequent chapters, we will discuss the stock acquisition case where the acquired company and its books remain intact and consolidated financial statements are prepared periodically. In such cases, the acquiring company debits an account "Investment in Subsidiary" rather than transferring the underlying assets and liabilities onto its own books.

Note that the distinction between an asset acquisition and a stock acquisition does not imply anything about the medium of exchange or consideration used to consummate the acquisition. Thus a firm may gain control of another firm in a stock acquisition using cash, debt, stock, or some combination of the three as consideration. Alternatively, a firm may acquire the total assets of another firm using cash, debt, stock, or some combination of the three. There are two independent issues related to the consummation of a combination: what is acquired (assets or stock) and what is given up (the consideration for the combination). These are shown in Figure 1-1.

In an asset acquisition, a firm must acquire 100% of the assets of the other firm. In a stock acquisition, a firm may obtain control by purchasing 50% or more of the voting common stock (or possibly even less). This introduces one of the most obvious advantages of the stock acquisition over the asset acquisition: a lower total cost in many cases. Also, in a stock acquisition, direct formal negotiations with the acquired firm's management may be avoided. Further, there may be advantages to maintaining the acquired firm as a separate legal entity. The possible advantages include liability limited to the assets of the individual corporation and greater flexibility in filing individual or consolidated tax returns. Finally, regulations pertaining to one of

¹⁶ *Gigaom.com* "In AT&T & T-Mobile Merger, Everybody Loses," by Om Malik, 3/20/2011.

FIGURE 1-1

| What Is Acquired: | What Is Given Up: |
|---|---|
| Net Assets of S Company (Assets and Liabilities) | 1. Cash 2. Debt 3. Stock 4. Combination of Above |
| Common Stock of S Company | |

the firms do not automatically extend to the entire merged entity in a stock acquisition. A stock acquisition has its own complications, however, and the economics and specifics of a given situation will dictate the type of acquisition preferred.

Other terms related to mergers and acquisitions merit mention. For example, business combinations are sometimes classified by method of combination into three types—statutory mergers, statutory consolidations, and stock acquisitions. However, the distinction between these categories is largely a technicality, and the terms **mergers**, **consolidations**, and **acquisitions** are popularly used interchangeably.

A **statutory merger** results when *one company acquires all the net assets of one or more other companies through an exchange of stock, payment of cash or other property, or issue of debt instruments (or a combination of these methods)*. The acquiring company survives, whereas the acquired company (or companies) ceases to exist as a separate legal entity, although it may be continued as a separate division of the acquiring company. Thus, if A Company acquires B Company in a statutory merger, the combination is often expressed as

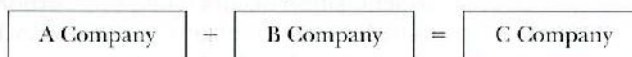
Statutory Merger



The boards of directors of the companies involved normally negotiate the terms of a plan of merger, which must then be approved by the stockholders of each company involved. State laws or corporation bylaws dictate the percentage of positive votes required for approval of the plan.

A **statutory consolidation** results when *a new corporation is formed to acquire two or more other corporations through an exchange of voting stock; the acquired corporations then cease to exist as separate legal entities*. For example, if C Company is formed to consolidate A Company and B Company, the combination is generally expressed as

Statutory Consolidation



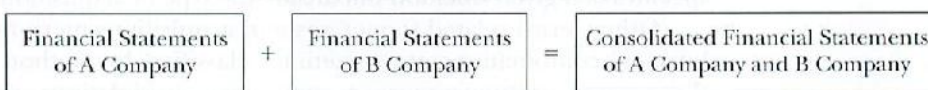
Stockholders of the acquired companies (A and B) become stockholders in the new entity (C). The combination of *Chrysler Corp.* and *Daimler-Benz* to form *DaimlerChrysler* is an example of this type of consolidation. The acquired companies in a statutory consolidation may be operated as separate divisions of the new corporation, just as they may under a statutory merger. Statutory consolidations require the same type of stockholder approval as do statutory mergers.


 IN
THE
NEWS

Synergistic deals may be viable even in the current environment, given adequate flexibility and preparation. Although the successful financing of large deals depends largely on capital markets, local middle market deals—say, less than \$20 million—more often rely on a combination of commercial loans, seller financing, and equity from private sources or a private equity group.¹⁷

A **stock acquisition** occurs when *one corporation pays cash or issues stock or debt for all or part of the voting stock of another company, and the acquired company remains intact as a separate legal entity*. When the acquiring company acquires a controlling interest in the voting stock of the acquired company (for example, if A Company acquires 50% of the voting stock of B Company), a parent–subsidiary relationship results. Consolidated financial statements (explained in later chapters) are prepared and the business combination is often expressed as

Consolidated Financial Statements



TEST YOUR KNOWLEDGE

NOTE: Solutions to *Test Your Knowledge* questions are found at the end of each chapter before the end-of-chapter questions.


 1.1

Short Answer

1. Name the following takeover defense tactics:
 - a. Issuing stock rights to existing shareholders, enabling them to purchase additional shares at a price below market value, but exercisable only in the event of a potential takeover. _____
 - b. The purchase of a controlling interest in the target firm by its managers and third-party investors, who usually incur substantial debt in the process and subsequently take the firm private. _____
 - c. Encouraging a third firm, more acceptable to the target company management, to acquire or merge with the target company. _____

Multiple Choice

2. Which one of the following statements is *incorrect*?
 - a. In an asset acquisition, the books of the acquired company are closed out, and its assets and liabilities are transferred to the books of the acquirer.
 - b. In many cases, stock acquisitions entail lower total cost than asset acquisitions.
 - c. Regulations pertaining to one of the firms do not automatically extend to the entire merged entity in a stock acquisition.
 - d. A stock acquisition occurs when one corporation pays cash, issues stock, or issues debt for all or part of the voting stock of another company; and the acquired company dissolves and ceases to exist as a separate legal entity.
3. Which of the following can be used as consideration in a stock acquisition?
 - a. Cash
 - b. Debt
 - c. Stock
 - d. Any of the above may be used

¹⁷“The Credit Puzzle,” by Lou Banach and Jim Gettel, *Mergers & Acquisitions*, December 2008.

TAKEOVER PREMIUMS

A **takeover premium** is the term applied to the excess of the amount offered, or agreed upon, in an acquisition over the prior stock price of the acquired firm. It is not unusual for the takeover premium to be as high as 100% of the target firm's market share price before the acquisition, and the average hovered around 40% to 50% into the late 1990s. In the face of the already high stock prices of this period, speculation was mixed as to the future of takeover premiums. Some experts predicted the premiums would shrink, leading to "takeunders" in some cases where companies are acquired below the listed stock prices. These predictions found some subsequent fulfillment as premiums in 2006 declined to around 20%.



IN
THE
NEWS

During March of 2006, the Capital One Financial Corporation agreed to acquire the North Fork Bancorporation for about \$14.6 billion in cash and stock. North Fork shareholders will receive a mix of cash and Capital One shares, representing a 22.8% premium over the closing price of North Fork shares.¹⁸

Possible reasons acquirers are willing to pay high premiums vary. One factor is that the acquirers' own stock prices may be at a level which makes it attractive to issue stock (rather than cash) to consummate the acquisition. Another factor is the availability of relatively cheap credit for mergers and acquisitions.

Bidders may have private information about the target firm suggesting that it is worth more than its current market value or has assets not reported on the balance sheet (such as in-process research and development). Alternatively, companies desperate to boost earnings may believe that growth by acquisitions is essential to survive in the global marketplace and that the competition necessitates the premiums. At the other end of the spectrum, a final possibility, which cannot be entirely ruled out, is that managers eager for growth may simply pay too much.

One research study presented evidence that higher premiums were offered for firms with high cash flows, relatively low growth opportunities, and high tax liabilities relative to their equity values.¹⁹ Another study suggested that the bigger the ego of the acquiring firm's CEO, the higher the takeover premium, while still another suggested that any premium over 25% is extremely risky.²⁰ Some compensation analysts argue that the massive options payouts to executives combined with golden parachutes provide an unhealthy incentive for executives to negotiate mergers, citing Chrysler's merger with Daimler-Benz as an example.²¹

Takeover premiums have attracted so much attention that some strategists (e.g., Paine Webber's Edward Kerschner) have advised clients looking for investments to choose stocks that might get taken over. Cautious financial advisors point out that

¹⁸ *The New York Times*, "Capital One Reported in Deal for North Fork," by Andrew Ross Sorkin and Eric Dash, March 13, 2006, p. A18.

¹⁹ The study, entitled "Free Cash Flow and Stockholder Gains in Going Private Transactions," was conducted by Lehn and Poulsen (*Journal of Finance*, July 1989, pp. 771-787). Also see "The Case against Mergers," by Phillip Zweig, *Business Week*, 10/30/95, pp. 122-130.

²⁰ "Acquisition Behavior, Strategic Resource Commitments and the Acquisition Game: A New Perspective on Performance and Risk in Acquiring Firms," by Mark Sirower, doctoral dissertation, Columbia University, 1994.

²¹ *WSJ*, "Chrysler Executives May Reap Windfall," by Gregory White, 5/13/98, p. A3.

lofty stock prices are a double-edged sword for financial buyers because they mean high prices for both companies' stocks and costlier acquisitions. Also, when stock prices fluctuate, the agreed-upon purchase price may suddenly appear more or less attractive than it did at the time of agreement. For example, a proposed acquisition of *Comsat Corp.* by Lockheed Martin Corp. was announced in September 1998, with the acquisition valued at \$2.6 billion, of which 49% was to be paid in cash and the rest in Lockheed stock. When Lockheed Martin's stock price subsequently faltered enough to suggest a 16% drop in the total value of the transaction, Comsat shareholders questioned whether the consideration for the transaction was fairly priced.²²

IN THE NEWS

Some statistics suggest that of "6000 acquisitions, only 900 return the cost of capital. It is easy to do deals. It is very difficult to make them succeed."²³

AVOIDING THE PITFALLS BEFORE THE DEAL

IN THE NEWS

In a survey of 101 corporations that completed a merger or acquisition transaction of at least \$100 million, KPMG found that 93% of companies queried believed that their deal enhanced shareholder value and over a third said they would not do anything different in subsequent deals. However, KPMG's objective examination of the deals showed that only 31% of these deals improved value. KPMG concluded that many companies may not be prepared to make an honest assessment of the success of their deals in order to avoid making mistakes in future deals.²⁴

LO3 Factors to be considered in due diligence.

To consider the potential impact on a firm's earnings realistically, the acquiring firm's managers and advisors must exercise **due diligence** in considering the information presented to them. The factors to beware of include the following:

1. Be cautious in interpreting any **percentages** presented by the selling company. For example, the seller may be operating below capacity (say, at 60% of capacity), but the available capacity may be for a product that is unprofitable or that is concentrated at a specific location, while the desirable product line (which the acquirer wishes to expand) is already at capacity.
2. Don't neglect to include **assumed liabilities** in the assessment of the cost of the merger. The purchase price for a firm's assets is the sum of the cash or securities issued to consummate the merger **plus** any liabilities assumed. This is equivalent to viewing the purchase price for a firm's **net** assets (assets **minus** liabilities assumed) as the sum of the cash or securities issued to consummate the merger.

²² WJ, "Lockheed Bid for Comsat Hits Obstacles," by Anne Marie Squeo, 6/11/99, p. A3.

²³ M&A, "How Acquirers Can Be Blindsided by the Numbers," May/June 1997, p. 29.

²⁴ KPMG Transaction Services, "The Morning After—Driving for Post Deal Success," January 31, 2006.



An important part of a buyer's preparation involves the development of a due diligence report (sometimes by a public accounting firm) for the purpose of uncovering "skeletons in the closet" (like vendor reliance or customer concentrations). These reports offer a fairly objective perspective of the business, so sharing them with potential lenders is one way of building trust and confidence in the collateral and cash flow. Most lenders prefer a 1-to-1 loan-to-collateral ratio in any deal, and regular monitoring through a monthly borrowing base. A lot of the scrutiny by senior lenders gets directed to the buyer's credentials and familiarity with the industry.²⁵

In addition to liabilities that are on the books of the acquired firm, be aware of the possibility of less obvious liabilities. FASB ASC Section 805-20-25 [recognition] requires an acquiring firm to recognize at fair value all assets acquired and liabilities assumed, whether or not shown in the financial statements of the acquired company.²⁶

Furthermore, FASB ASC paragraph 805-30-25-5 states that any *contingent* assets or liabilities that are acquired or assumed as part of a business combination must be measured and recognized at their fair values (provided they satisfy the definition of assets or liabilities), **even if they do not meet the usual recognition criteria for recording contingent items** (FASB ASC paragraph 450-20-25-2).²⁷

FASB ASC Topic 805 [Business Combinations] also states that any costs associated with restructuring or exit activities should not be treated as liabilities at the acquisition date unless they meet the criteria for recognition laid out in FASB ASC paragraph 420-10-15-2.²⁸ Instead, costs not meeting these criteria should be expensed in the period in which they are incurred. For example, future costs expected with regard to exiting an activity of the target, terminating the employment of the acquiree's employees, or relocation of those employees are not accounted for as part of the business combination.²⁹

3. Watch out for the impact on earnings of the **allocation of expenses** and the effects of production increases, standard cost variances, LIFO liquidations, and by-product sales. For example, a firm that is planning to be acquired may grow inventory levels in order to allocate its fixed costs over more units, thus decreasing the cost of goods sold and increasing the bottom line. However, the inventory level that is acquired may be excessive and ultimately costly.

²⁵ "The Credit Puzzle," by Lou Banach and Jim Gettel, *Mergers & Acquisitions*, December 2008.

²⁶ See the section later in the chapter on the FASB Codification.

²⁷ FASB ASC paragraph 450-20-25-2 (*FASB Statement No. 5*) states that, in general, contingent liabilities (and related losses) should be accrued if they are both probable and reasonably estimable while contingent assets (and gains) should usually not be reflected to avoid misleading implications about their realizability. These conditions still apply for noncontractual contingent liabilities unless it is *more likely than not* that an asset or liability exists. The number of deals with contingent payments nearly doubled between 1997 and 2006, while the dollar value of those deals more than doubled (with the earn-out value portion rising from 3.3 billion dollars in 1997 to a high of 6.1 billion dollars in 2001 and leveling back to 5.3 billion dollars in 2006). See Chapter 2 for further details.

²⁸ FASB ASC paragraph 420-10-25-2 (*FASB Statement No. 146*) reiterates the definition of a liability and states that only present obligations to others are liabilities. It clarifies by specifying that an obligation becomes a present obligation when a past transaction or event leaves little or no discretion to avoid settlement, and that an exit or disposal plan, by itself, does not create a present obligation.

²⁹ FASB's new Codification system, referenced here, is discussed near the end of Chapter 1 and in greater detail in Appendix ASC, which appears at the back of the book.

ILLUSTRATION 1-3

Mode of Payment in M&A Deals

| Year | Cash | | Stock | | Combination | |
|------|------|-------|-------|-------|-------------|-------|
| | # | % | # | % | # | % |
| 2002 | 1260 | 63.8% | 402 | 20.4% | 313 | 15.8% |
| 2003 | 1535 | 74.2% | 311 | 15.0% | 224 | 10.8% |
| 2004 | 1734 | 73.9% | 288 | 12.3% | 326 | 13.9% |
| 2005 | 1988 | 76.0% | 282 | 10.8% | 346 | 13.2% |
| 2006 | 2014 | 78.9% | 212 | 8.3% | 328 | 12.8% |

Source: *Mergers & Acquisitions*, January 2007.

- Note any **nonrecurring items** that may have artificially or temporarily boosted earnings. In addition to nonrecurring gains or revenues, look for recent **changes in estimates, accrual levels, and methods**. While material changes in method are a required disclosure under GAAP, the rules on materiality are fuzzy, and changes in estimates and accruals are frequently not disclosed (See Illustration 1-3).



IN
THE
NEWS

"While everything in the offering memorandum may very well be true, although not necessarily, the facts are designed to make the company look better than it would if an analyst were to dig into those facts."³⁰

- Be careful of **CEO egos**. Striving to be number one may make business sense, but not everyone can hold that spot. One CEO drew both praise and criticism with his deal-of-the-month style. He stated, "There are the big dogs, there are the ankle-biters, and then there are those caught in the middle." The midsize firms have to combine, he claimed.³¹

DETERMINING PRICE AND METHOD OF PAYMENT IN BUSINESS COMBINATIONS

LO 6 Factors affecting price and method of payment.

Whether an acquisition is structured as an asset acquisition or a stock acquisition, the acquiring firm must choose to finance the combination with cash, stock, or debt (or some combination). The cash-financed portion of acquisition prices dropped from 42.3% in 1994 to 13.4% in 1998, according to Securities Data Co. of Newark, New Jersey. This represented the lowest share of cash in over ten years.³² Note that the dollar volume of cash used in 1998 acquisitions was not down, but rather the percentage of cash included in the total acquisition price. The proportion of cash

³⁰ *M&A*, "How Acquirers Can Be Blindsided by the Numbers," May/June 1997, p. 29.

³¹ *WSJ*, "In the New Mergers Conglomerates Are Out, Being No. 1 Is In," by Bernard Wysocki Jr., 12/31/97, p. A1.

³² *WSJ*, "Mergers Reached This Year Are Using the Lowest Share of Cash in Ten Years," by Greg Ip, 4/16/98, p. C1.

included in the total cost increased again in the deals of the early part of the 21st century. The number of cash deals rose by 60% from 2002 to 2006, while the number of stock-only deals dropped by about 47% and the number of combination deals remained relatively flat.³³

The trends are often explained by fluctuating stock valuations. The higher the acquiring firm's stock valuation, the fewer shares are needed to pay for the acquisition. This means less dilution to existing shareholders, a frequent concern in the planning stages of a proposed acquisition. When stock prices slumped in the middle of 2001, merger activity slowed as well. But by the middle of the decade, both were booming once more. Then, merger activity rose steadily from 2002 to 2006, remained approximately the same in 2007 as in 2006, and then fell off by the end of 2008 as stock prices plunged and the economy slid into a recession. By 2010, many of the mega-mergers in the making were once again looking to use all (or mostly) stock, as the market moved up.



In the latest merger run in 2005, the number of deals using stock decreased to about 11% of total deals, while in 2000, the percentage of deals using all stock averaged around 27%. Stock-for-stock swaps are more common when stock prices are increasing.³⁴

When a business combination is effected through an open-market acquisition of stock, no particular problems arise in connection with determining price or method of payment. Price is determined by the normal functioning of the stock market, and payment is generally in cash, although some or all of the cash may have to be raised by the acquiring company through debt or equity issues. Effecting a combination may present some difficulty if there are not enough willing sellers at the open-market price to permit the acquiring company to buy a majority of the outstanding shares of the company being acquired. In that event, the acquiring company must either negotiate a price directly with individuals holding large blocks of shares or revert to an open tender offer.

When a business combination is effected by a stock swap, or exchange of securities, both price and method of payment problems arise. In this case, the price is expressed in terms of a **stock exchange ratio**, which is generally defined as *the number of shares of the acquiring company to be exchanged for each share of the acquired company*, and constitutes a **negotiated price**. It is important to understand that each constituent of the combination makes two kinds of contributions to the new entity—net assets and future earnings. The accountant often becomes deeply involved in the determination of the values of these contributions. Some of the issues and the problems that arise are discussed in the following section.

Net Asset and Future Earnings Contributions

Determination of an equitable price for each constituent company, and of the resulting exchange ratio, requires the valuation of each company's net assets as well as their expected contribution to the future earnings of the new entity. The accountant

³³ *Mergers & Acquisitions*, January 2007, page 57.

³⁴ *WSJ*, "Year-End Review of Markets & Finance 2005," by Dennis Berman, 1/3/06, p. R1.

EXCESS EARNINGS APPROACH TO ESTIMATING GOODWILL

1. Identify a normal rate of return on assets for firms similar to the company being targeted. Statistical services are available to provide averages, or a normal rate may be estimated by examining annual reports of comparable firms. The rate may be estimated as a return on either total assets or on *net* identifiable assets (assets other than goodwill minus liabilities).
2. Apply the rate of return identified in step 1 to the level of identifiable assets (or net assets) of the target to approximate what the “normal” firm in this industry might generate with the same level of resources. We will refer to the product as “normal earnings.”
3. Estimate the expected future earnings of the target. Past earnings are generally useful here and provide a more objective measure than management’s projections, although both should be considered. Exclude any nonrecurring gains or losses (extraordinary items, gains and losses from discontinued operations, etc.) from past earnings if they are used to estimate future earnings.
4. Subtract the normal earnings calculated in step 2 from the expected target earnings from step 3. The difference is “excess earnings.” If the normal earnings are greater than the target’s expected earnings, then no goodwill is implied under this approach.
5. To compute estimated goodwill from “excess earnings,” we must assume an appropriate time period and a discount rate. The shorter the time period and the higher the discount rate, the more conservative the estimate. If the excess earnings are expected to last indefinitely, the present value of a perpetuity may be calculated simply by dividing the excess earnings by the discount rate. For finite time periods, use present-value tables or calculations to compute the present value of an annuity. Because of the assumptions needed in step 5, a range of goodwill estimates may be obtained simply by varying the assumed discount rate and/or the assumed discount period.
6. Add the estimated goodwill from step 5 to the fair value of the firm’s net identifiable assets to arrive at a possible offering price.

is often called upon to aid in determining net asset value by assessing, for example, the expected collectibility of accounts receivable, current replacement costs for inventories and some fixed assets, and the current value of long-term liabilities based on current interest rates. To estimate current replacement costs of real estate and other items of plant and equipment, the services of appraisal firms may be needed.

Estimation of the value of goodwill to be included in an offering price is subjective. A number of alternative methods are available, usually involving the discounting of expected future cash flows (or free cash flows), earnings, or excess earnings over some period of years. Generally, the use of free cash flows or earnings yields an estimate of the entire firm value (including goodwill), whereas the use of excess earnings yields an estimate of the goodwill component of total firm value. We next describe the steps in the excess earnings approach and then follow with an illustration.

197 Estimating goodwill.

Estimating Goodwill and Potential Offering Price Wanna Buy Company is considering acquiring *Hot Stuff Inc.* and is wondering how much it should offer. Wanna Buy makes the following computations and assumptions to help in the decision.

- a. Hot Stuff’s identifiable assets have a total fair value of \$7,000,000. Hot Stuff has liabilities totalling \$3,200,000. The assets include patents and copyrights with a fair value approximating book value, buildings with a fair value 50% higher than book value, and equipment with a fair value 25% lower than book value. The remaining lives of the assets are deemed to be approximately equal to those used by Hot Stuff.

- b. Hot Stuff's pretax income for the year 2006 was \$1,059,000, which is believed by Wanna Buy to be more indicative of future expectations than any of the preceding years. The net income of \$1,059,000 included the following items, among others:

| | |
|--|----------|
| Amortization of patents and copyrights | \$50,000 |
| Depreciation on buildings | 360,000 |
| Depreciation on equipment | 80,000 |
| Extraordinary gain | 250,000 |
| Loss from discontinued operations | 175,000 |
| Pension expense | 59,000 |

- c. The normal rate of return on net assets for the industry is 14%.
 d. Wanna Buy believes that any excess earnings will continue for seven years and that a rate of return of 15% is required on the investment.

Based on the assumptions above and ignoring tax effects, we will first calculate an estimation of the implied goodwill, and then use that estimate to arrive at a reasonable offering price for Hot Stuff.

$$\text{Normal earnings for similar firms: } (\$7,000,000 - \$3,200,000) \times 14\% = \$532,000$$

Expected earnings of target:

| | | |
|---|----------------|----------------|
| Pretax income of Hot Stuff | | \$1,059,000 |
| Add: Losses on discontinued operations | 175,000 | |
| Reduced depreciation on equipment | <u>20,000</u> | <u>195,000</u> |
| Subtotal | | 1,254,000 |
| Subtract: Additional depreciation on building | 180,000 | |
| Extraordinary gain | <u>250,000</u> | <u>430,000</u> |
| <i>Target's expected future earnings</i> | | 824,000 |

$$\text{Excess earnings of target: } \$824,000 - \$532,000 = \$292,000 \text{ per year}$$

Present value of excess earnings (ordinary annuity) for seven years at 15% (see Table A2 in Appendix PV at back of textbook):

$$\text{Estimated goodwill: } \$292,000 \times 4.16042 = \$1,214,843$$

$$\begin{aligned} \text{Implied offering price} &= \text{Fair value of assets} - \text{Fair value of liabilities} + \text{Estimated goodwill} \\ &= \$7,000,000 - \$3,200,000 + \$1,214,843 = \$5,014,843. \end{aligned}$$

In the illustration above, in arriving at the target's expected future earnings, we ignored the items that are expected to continue after the acquisition, such as the amortization of the patents and copyrights and the pension expense. We backed out nonrecurring gains and losses on extraordinary items or discontinued operations. We adjusted the prior reported earnings for the expected increase in depreciation on the building (50% higher than in the past), leading to a decrease in projected earnings. In contrast, we increased projected earnings for the decrease in equipment depreciation (25% lower than in the past). In practice, more specific information should be available as to which components of earnings are expected to continue at the same level, which might be reduced because of economies or cost-cutting plans, and which might increase because of transition costs. The better the information used in the computation, the better the estimate of goodwill and offering price.

Where the constituent companies have used different accounting methods, the accountant will often need to reconstruct their financial statements on the basis of

agreed-upon accounting methods in order to obtain reasonably comparable data. Once comparable data have been obtained for a number of prior periods, they are analyzed further to project future contributions to earnings. The expected contributions to future earnings may vary widely among constituents, and the exchange ratio should reflect this fact. The whole process of valuation, of course, requires the careful exercise of professional judgment. Ultimately, however, the exchange ratio is determined by the bargaining ability of the individual parties to the combination.

Once the overall values of relative net asset and earnings contributions have been agreed on, the types of securities to be issued by the new entity in exchange for those of the combining companies must be determined. In some cases a single class of stock will be issued; in other cases equity may require the use of more than one class of security.

The concepts of earnings **dilution** and **accretion** are critical to the valuation of a merger. Does the merger increase or decrease expected earnings performance of the acquiring institution? From a financial and shareholder perspective, the price paid for a firm is hard to justify if earnings per share declines. When this happens, the acquisition is considered **dilutive**. Conversely, if the earnings per share increases as a result of the acquisition, it is referred to as an **accretive** acquisition.



IN
THE
NEWS

Upon the agreement to purchase Creo, Inc. for \$900 million in cash, Eastman Kodak Company's CEO Daniel Carp stated that the "acquisition will result in some modest earnings dilution for the remainder of 2005." However, Carp expects that the Creo transaction will be accretive in 2006, adding "at least 5 cents to per-share operational earnings, driven by cost savings and revenue growth available to the combined entity."³⁵

Many deals lower earnings per share initially but add significantly to value in later years. While initial dilution may not be a deal killer, however, many managers feel that they cannot afford to wait too long for a deal to begin to show a positive return. Opinions are divided, however, on what drives the market in relation to mergers and acquisitions, nor do research studies offer conclusive evidence on the subject. Bart Madden, a partner in a valuation advisory firm in Chicago, remarked, "I totally disagree that the market is EPS driven. From the perspective of the owner or manager of capital, what matters is cash in, cash out, not reported earnings."³⁶ He acknowledges, however, that CFOs, who "live in a world of accounting rules," are concerned about reported earnings.



IN
THE
NEWS

Build-A-Bear Workshop, the teddy-bear-stuffing retailer, purchased U.K.-based rival Bear Factory for \$41.4 million in cash to help solidify Build-A-Bear's global position. Build-A-Bear expected the acquisition to be accretive to earnings per share by 2007.³⁷

Evaluating Firm Performance In Appendix A, we provide a structured approach using ratios to evaluate the performance of a firm. This approach could be used to evaluate the financial performance of a potential target or in evaluating the

³⁵ *Business Wire*, "Kodak Announces Agreement to Acquire Creo Inc.," 1/31/05.

³⁶ CFO, "Say Goodbye to Pooling," by Ian Springsteel, February 1997, p. 79.

³⁷ *MSNBC.com*, "When Bears Collide," by Rick Aristotle Mumariz, 3/6/06.

strength of an acquirer. The ratio approach begins by analyzing the change in return on equity (ROE). This ratio is then decomposed into a return on asset (ROA) and a leverage ratio (total assets divided by equity). These ratios are further decomposed into other relevant combinations of variables. This structured approach allows the user to zero in on areas that have changed or that need to be examined in more detail.

ALTERNATIVE CONCEPTS OF CONSOLIDATED FINANCIAL STATEMENTS

LO 8 Economic entity and parent company concepts.

As mentioned previously, business combinations may take the form of asset acquisitions or stock acquisitions. When the combination is consummated as an asset acquisition, the books of the acquired company are closed out and the accounting takes place on the books of the acquirer, as illustrated in Chapter 2. When the combination is consummated as a stock acquisition, both companies continue to prepare journal and ledger entries separately through future periods. Periodically the two sets of books are combined into one through a procedure sometimes referred to as the **consolidating process** to produce a set of consolidated financial statements. Chapters 3 through 9 deal with many of the technical procedures needed to carry out this process. Here we present a brief introduction to the more theoretical concepts involved in accounting for the consolidated entity. The question that arises relates to the primary purpose of the consolidated financial statements and to the relationships between the affiliated companies and their shareholders, keeping in mind that a certain group of shareholders may own a portion of the acquired company (often referred to as the **subsidiary**) but none of the acquiring company (or **parent**).

Historically, practice in the U.S. has reflected a compromise between two general concepts of consolidation given various designations in the accounting literature. However, in FASB ASC topics 805 [Business Combinations] and 810 [Consolidation] (formerly *FASB Statements No. 141-R* and *No. 160*), the FASB indicates that the economic entity concept is now to be embraced more fully. Next, let us review the basic differences between the alternative concepts. For our purposes, we will refer to them as the **parent company concept** and the **economic entity concept** (sometimes called the **economic unit concept**). A third concept, **proportionate consolidation**, was rejected by the FASB.

Although only one of these—the economic entity concept—is embraced by current GAAP and thus integrated throughout this text, the two more popular concepts are described below (as defined by the Financial Accounting Standards Board).³⁸

Parent Company Concept

The parent company concept emphasizes the interests of the parent's shareholders. As a result, the consolidated financial statements reflect those stockholder interests in the parent itself, plus their undivided interests in the net assets of the parent's subsidiaries. The consolidated balance sheet is essentially a

³⁸ *FASB Discussion Memorandum, "Consolidation Policy and Procedures"* FASB (Norwalk, CT: September 10, 1991), pars. 63 and 64.

modification of the parent's balance sheet with the assets and liabilities of all subsidiaries substituted for the parent's investment in subsidiaries. The stockholders' equity of the parent company is also the stockholders' equity of the consolidated entity. Similarly, the consolidated income statement is essentially a modification of the parent's income statement with the revenues, expenses, gains, and losses of subsidiaries substituted for the parent's income from investment in subsidiaries. These multi-line substitutions for single lines in the parent's balance sheet and income statement are intended to make the parent's financial statements more informative about the parent's total ownership holdings.

Economic Entity Concept

The economic entity concept emphasizes control of the whole by a single management. As a result, under this concept, consolidated financial statements are intended to provide information about a group of legal entities—a parent company and its subsidiaries—operating as a single unit. The assets, liabilities, revenues, expenses, gains, and losses of the various component entities are the assets, liabilities, revenues, expenses, gains, and losses of the consolidated entity. Unless all subsidiaries are wholly owned, the business enterprise's proprietary interest (assets less liabilities) is divided into the controlling interest (stockholders or other owners of the parent company) and one or more noncontrolling interests in subsidiaries. Both the controlling and the noncontrolling interests are part of the proprietary group of the consolidated entity, even though the noncontrolling stockholders' ownership interests relate only to the affiliates whose shares they own.

The parent company concept represents the view that the primary purpose of consolidated financial statements is to provide information relevant to the controlling stockholders. The parent company effectively controls the assets and operations of the subsidiary. Noncontrolling stockholders do not exercise any ownership control over the subsidiary company or the parent company. Thus, the parent company concept places emphasis on the needs of the controlling stockholders, and the noncontrolling interest is essentially relegated to the position of a claim against the consolidated entity. Thus, the noncontrolling, or minority, interest should be presented as a liability in the consolidated statement of financial position under the parent company concept or, as described in the next section, as a separate component before stockholders' equity.

The economic entity concept represents the view that the affiliated companies are a separate, identifiable economic entity. Meaningful evaluation by any interested party of the financial position and results of operations of the economic entity is possible only if the individual assets, liabilities, revenues, and expenses of the affiliated companies making up the economic entity are combined. The economic entity concept treats both controlling and noncontrolling stockholders as contributors to the economic unit's capital. Thus, the noncontrolling, or minority, interest should be presented as a component of equity in the consolidated financial statement under the economic entity concept.

The FASB stated that it had considered and rejected the concept of proportionate consolidation for subsidiaries. This concept, although not used in current or past practice, has been advocated by some as an alternative to full consolidation. Under proportionate consolidation, the consolidated statements would include only a portion, based on the parent's ownership interest, of the subsidiary's assets,

liabilities, revenues, expenses, gains, and losses. The FASB stated that because the consolidated entity has the power to direct the use of all the assets of a controlled entity, omitting a portion of those assets from the statements would not be representationally faithful. Similarly, omitting part of the revenues and expenses from the consolidated income statement would not be representationally faithful.

Differences between the concepts are relevant only to less than wholly owned subsidiaries; they center on conflicting views concerning answers to three basic questions:

1. What is the nature of a noncontrolling interest?
2. What income figure constitutes consolidated net income?
3. What values should be reported in the consolidated balance sheet?

A related issue concerns the percentage (total or partial) of unrealized inter-company profit to be eliminated in the determination of consolidated balances.

Noncontrolling Interest

Under the **economic entity concept**, a *noncontrolling interest is a part of the ownership equity in the entire economic unit*. Thus, a noncontrolling interest is of the same general nature and is accounted for in essentially the same way as the controlling interest (i.e., as a component of owners' equity). Under the *parent company concept*, the nature and classification of a noncontrolling interest are unclear. The parent company concept views the consolidated financial statements as those of the parent company. From that perspective, the noncontrolling interest is similar to a liability; but because the parent does not have a present obligation to pay cash or release other assets, it is not a liability based on the FASB's technical definition of a "liability." Nor is it a true component of owners' equity since the noncontrolling investors in a subsidiary do not have an ownership interest in the subsidiary's parent. Consequently, the parent company concept theoretically supports reporting the noncontrolling interest below liabilities but above stockholders' equity in the consolidated balance sheet.

Consolidated Net Income

Under the **parent company concept**, *consolidated net income consists of the realized combined income of the parent company and its subsidiaries after deducting noncontrolling interest in income*; that is, the noncontrolling interest in income is deducted as an expense item in determining consolidated net income. This view emphasizes that the parent company stockholders are directly interested in their share of the results of operations as a measure of earnings in relation to their investment and dividend expectations.

Under the **economic entity concept**, consolidated net income consists of the total realized combined income of the parent company and its subsidiaries. The total combined income is then allocated proportionately to the noncontrolling interest and the controlling interest. Noncontrolling interest in income is considered an allocated portion of consolidated net income, rather than an element in the determination of consolidated net income. The concept emphasizes the view that the consolidated financial statements represent those of a single economic unit with several classes of stockholder interest. Thus, noncontrolling interest in net assets is

considered a separate element of stockholders' equity, and the noncontrolling interest in net income reflects the share of consolidated net income allocated to the noncontrolling stockholders.

Consolidated Balance Sheet Values

In the case of less than wholly owned subsidiaries, the question arises as to whether to value the subsidiary assets and liabilities at the *total* fair value implied by the price paid for the controlling interest, or at their book value adjusted only for the excess of cost over book value paid by the parent company. For example, assume that P Company acquires a 60% interest in S Company for \$960,000 when the book value of the net assets and of the stockholders' equity of S Company is \$1,000,000. The implied fair value of the net assets of S Company is \$1,600,000 ($\$960,000 / .6$), and the difference between the implied fair value and the book value is \$600,000 ($\$1,600,000 - \$1,000,000$). For presentation in the consolidated financial statements, should the net assets of S Company be written up by \$600,000 or by 60% of \$600,000?

Application of the *parent company concept* in this situation restricts the write-up of the net assets of S Company to \$360,000 ($.6 \times \$600,000$) on the theory that the write-up should be restricted to the amount actually paid by P Company in excess of the book value of the interest it acquires [$\$960,000 - (.6 \times \$1,000,000) = \$360,000$]. In other words, the value assigned to the net assets should not exceed cost to the parent company. Thus, the net assets of the subsidiary are included in the consolidated financial statements at their book value (\$1,000,000) plus the **parent company's share** of the difference between fair value and book value ($.6 \times \$600,000$) = \$360,000, or at a total of \$1,360,000 on the date of acquisition. Noncontrolling interest is reported at its percentage interest in the **reported book value** of the net assets of S Company, or \$400,000 ($.4 \times \$1,000,000$).

Application of the *economic entity concept* results in a write-up of the net assets of S Company in the consolidated statements workpaper by \$600,000 to \$1,600,000 on the theory that the consolidated financial statements should reflect 100% of the net asset values of the affiliated companies. On the date of acquisition, the net assets of the subsidiary are included in the consolidated financial statements at their book value (\$1,000,000) plus **the entire difference** between their fair value and their book value (\$600,000), or a total of \$1,600,000. Noncontrolling interest is reported at its percentage interest in the **fair value** of the net assets of S Company, or \$640,000 ($.4 \times \$1,600,000$).

Regardless of the concept followed, the controlling interest in the net assets of the subsidiary reported in the consolidated financial statements is the same and is equal to P Company's cost, as demonstrated here:

| | <i>Parent Company Concept</i> | <i>Economic Unit Concept</i> |
|---|-----------------------------------|----------------------------------|
| Net assets of S Company included in consolidation | \$1,360,000 | \$1,600,000 |
| Less: Noncontrolling interest | 400,000 | 640,000 |
| Controlling interest (cost) | <u>\$ 960,000</u> | <u>\$ 960,000</u> |

While U.S. standards have, in the past, been more consistent with the parent company concept with respect to write-up of net assets, the implementation of *FASB*

Statements No. 141R and 160 [FASB ASC topics 805 and 810] results in a shift to the economic entity concept in this regard, among others.

Intercompany Profit

There are two alternative points of view as to the amount of intercompany profit that should be considered unrealized in the determination of consolidated income. The elimination methods associated with these two points of view are generally referred to as **total (100%) elimination** and **partial elimination**.

Proponents of total elimination regard all the intercompany profit associated with assets remaining in the affiliated group to be unrealized. Proponents of partial elimination regard only the parent company's share of the profit recognized by the selling affiliate to be unrealized. Under total elimination, the entire amount of unconfirmed intercompany profit is eliminated from combined income and the related asset balance. Under partial elimination, only the parent company's share of the unconfirmed intercompany profit recognized by the selling affiliate is eliminated.

Past and Future Practice

Past practice has viewed noncontrolling interest in income neither as an expense nor as an allocation of consolidated net income, but as a special equity interest in the consolidated entity's combined income that must be recognized when all the earnings of a less than wholly owned subsidiary are combined with the earnings of the parent company. Noncontrolling interest in net assets has been viewed neither as a liability nor as true stockholders' equity, but rather as a special interest in the combined net assets that must be recognized when all the assets and liabilities of a less than wholly owned subsidiary are combined with those of the parent company.

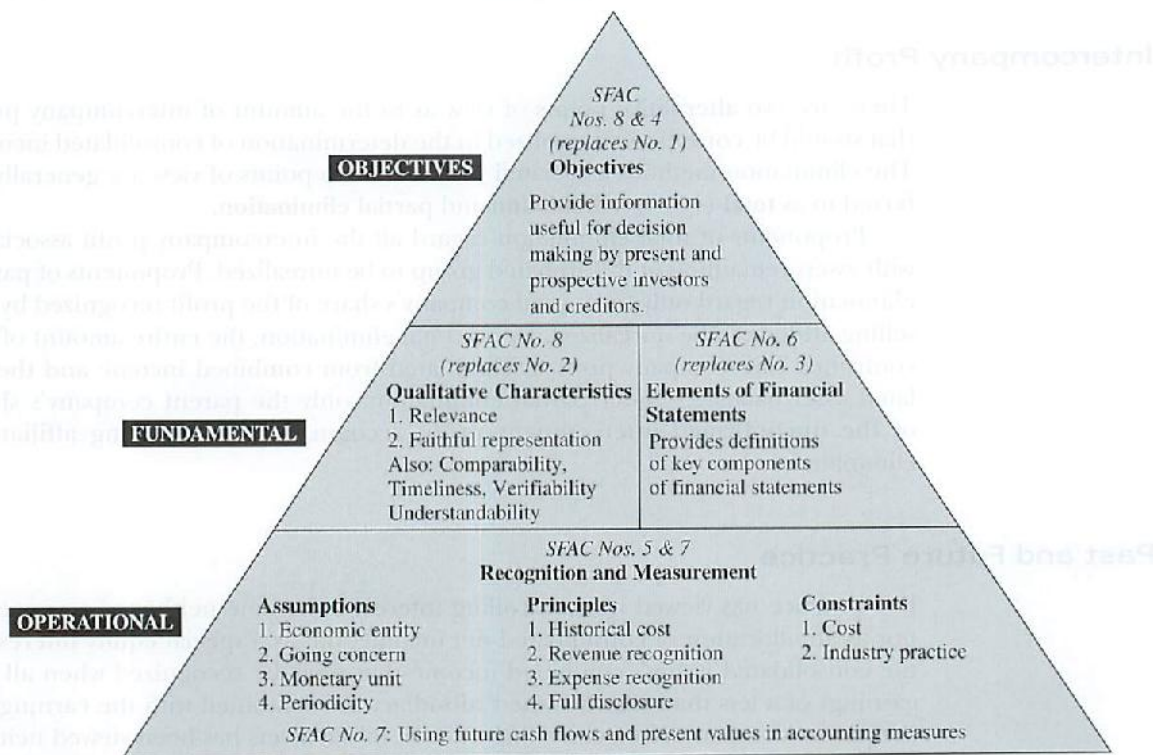
In contrast, under the new standards, the noncontrolling interest in income is viewed as an allocation of consolidated net income on the income statement, and the noncontrolling interest in net assets as a component of equity in the balance sheet.

Past and future accounting standards are, however, consistent in requiring the total elimination of unrealized intercompany profit in assets acquired from affiliated companies, regardless of the percentage of ownership.

FASB'S CONCEPTUAL FRAMEWORK

The Financial Accounting Standards Board (FASB) began the process of developing a conceptual framework for financial reporting in 1976, a process that continues to the present. The much-needed objective of providing a basis for standard setting and controversy resolution has, as expected, proved to be challenging. The statements of concepts issued to date are summarized in Figure 1-2. The reader should be aware that the FASB and the IASB are working on a joint project to converge their conceptual frameworks. The first phase has been completed with the issuance of Statement of Financial Accounting Concepts (SFAC) No. 8: Conceptual Framework for Financial Reporting—Chapter 1, *The Objective of General Purpose Financial Reporting*; and Chapter 3, *Qualitative Characteristics of Useful Financial Information* (a replacement of FASB Concepts Statements Nos. 1 and 2). New chapters and concepts are expected to be added. Concepts

FIGURE 1-2
Conceptual Framework for Financial Accounting and Reporting



Adapted from "Accounting for Financial Analysis," by W.C. Norby, *Financial Analysts Journal*, March–April 1982, p. 22.

Statements are not part of the *FASB Accounting Standards Codification*, which is the source of authoritative GAAP recognized by the FASB to be applied by nongovernmental entities. The Board recognizes that in certain respects current generally accepted accounting principles may be inconsistent with those that may derive from the objectives and fundamental concepts set forth in Concepts Statements. However, a Concepts Statement does not (a) require a change in existing U.S. GAAP; (b) amend, modify, or interpret the Accounting Standards Codification; or (c) justify either changing existing generally accepted accounting and reporting practices or interpreting the Accounting Standards Codification based on personal interpretations of the objectives and concepts in the Concepts Statements.

Joint Project of FASB and IASB on Conceptual Framework The objective of the joint project is to develop an improved common conceptual framework that provides a sound foundation for developing future standards. Such a framework is believed to be essential to the two Boards' goal of developing standards that are principles-based, internally consistent, and internationally converged. The new framework is expected to deal with a wide range of issues, and will build on the existing IASB and FASB frameworks, while also considering developments subsequent to the issuance of those frameworks.



One of the goals of the Boards, which is shared by their constituents, is for the standards to be clearly based on consistent principles that are rooted in fundamental concepts rather than a collection of conventions. The objective is for the body of standards taken as a whole, as well as the application of those standards, to be based on a sound, comprehensive, and internally consistent framework. Another important goal is to converge the standards of the two Boards. As the Boards strive to more closely align their agendas to achieve standard convergence, they will be hampered unless they are basing decisions on the same basic framework.

Economic Entity vs. Parent Concept and the Conceptual Framework

The parent concept, discussed in the preceding section, was the essential approach used in the U.S. until 2008 for accounting for business combinations (although there were some exceptions to a wholly applied parent concept, as previously addressed). The parent company concept is tied to the *historical cost* principle, which suggests that the best measure of valuation of a given asset is the price paid. Historical cost thus suggests that the purchase price of an acquired firm should be relied on in assessing the value of the acquired assets, including goodwill. One problem that arises from a theoretical perspective is how to value the noncontrolling interest, or the portion of the acquired firm's assets which did not change hands in an arm's length transaction. The historical cost perspective would suggest that those assets (or portions thereof) remain at their previous book values. This approach might be argued to produce more *reliable* or "representationally faithful" values, addressed in the FASB's conceptual framework as a desirable attribute of accounting information (*SPAC No. 8*).

In contrast, the economic entity concept is itself an integral part of the FASB's conceptual framework and is named specifically in *SPAC No. 5* as one of the basic assumptions in accounting. The economic entity assumption views economic activity as being related to a particular unit of accountability, and the standard indicates that a parent and its subsidiaries represent *one economic entity* even though they may include *several legal entities*. Thus, the recent shift to the economic entity concept seems to be entirely consistent with the assumptions laid out by the FASB for GAAP.



The economic entity concept might also be argued to produce more *relevant*, if not necessarily more reliable, information for users. The two primary characteristics of relevance and reliability (or representational faithfulness) often find themselves in conflict in any given accounting debate. For example, the view of many users is that *market value accounting* would provide far more *relevant* information for users than continued reliance on historical cost in general. Proponents of historical cost, however, argue that market valuations suffer from too much subjectivity and vulnerability to bias, and are much *less* representationally faithful.

In the joint project of the FASB and the IASB on the conceptual framework, the conclusion was reached that the entity perspective is more consistent with the fact that the vast majority of today's business entities have substance distinct from that of their capital providers. As such, the proprietary perspective does not reflect a realistic view of financial reporting. The Boards have not yet considered the effect that adoption of the entity perspective will have on phases of their project that have not yet been deliberated, and decisions related to those phases are being deferred.


 IN
THE
NEWS

Embedded in many of FASB's recent pronouncements have been a number of indicators of a shift away from historical cost accounting in the direction of fair value accounting. This shift drew a great deal of attention, much of it negative, when the financial crisis of 2008 became apparent. Critics claimed that values were dropping to artificially low values, forcing banks to take large write-downs, launching a desperate cycle from which they might not recover. Dennis Beresford, an accounting professor at the University of Georgia and chairman of the FASB from 1987 to 1997, explained, "It's intended to be more or less for orderly markets. But we don't have orderly markets these days. It's not so much that mark to market has people complaining, but marking to a particular market. Today it's more of fire-sale prices."³⁹

Overview of FASB's Conceptual Framework

LO 9 Statements of Financial Accounting Concepts.

The *Statements of Financial Accounting Concepts* issued by the FASB include the following:

SFAC No. 1 (replaced by SFAC No. 8): Objectives of Financial Reporting by Business Enterprises

SFAC No. 2 (replaced by SFAC No. 8): Qualitative Characteristics of Accounting Information

SFAC No. 3 (replaced by SFAC No. 6): Elements of Financial Statements of Business Enterprises

SFAC No. 4: Objectives of Financial Reporting by Nonbusiness Organizations

SFAC No. 5: Recognition and Measurement in Financial Statements of Business Enterprises

SFAC No. 6 (replaces SFAC No. 3): Elements of Financial Statements

SFAC No. 7: Using Cash Flow Information and Present Value in Accounting Measurements

SFAC No. 8: The Objective of General Purpose Financial Reporting and Qualitative Characteristics of Useful Financial Information

Please refer to Figure 1-2 for a brief summation of these statements. Our focus is on *SFAC No. 8*, *No. 6*, and *No. 5*. The remaining statements of concept include one that was subsequently replaced by *SFAC No. 6 (SFAC No. 3)*, one that relates primarily to the last three chapters of our textbook (*SFAC No. 4*), and *FASB Statement of Concept, No. 7*, which provides some information on the use of discounted cash flows and present values as a measurement approach. *SFAC No. 7* might be viewed as an expansion of *SFAC No. 5*, and is thus included in the same level in Figure 1-2.

Linking the Conceptual Framework to Advanced Accounting Issues

We begin with a brief discussion of the two *Statements of Concepts* which receive the least attention in the following paragraphs (*SFAC No. 4* and *SFAC No. 7*). With respect to *SFAC No. 4*, the Board believes that the objectives of reporting for government-sponsored entities should be, in general, similar to those of business

³⁹"Wall St. Points to Disclosure As Issue," by Carrie Johnson, Washingtonpost.com, September 23, 2008.

enterprises engaged in similar activities. Moving to *SFAC No. 7*, the use of present values is clearly relevant in the accounting for business combinations as it impacts the estimated valuation of goodwill (previously illustrated in Chapter 1), as well as other intangible assets acquired in a business combination. Just as clearly, the use of present values is hampered by issues of uncertainty, both about estimated cash flows and about appropriate discount rates. As stated in *SFAC No. 7*, the objective of using present values in an accounting measurement is to capture, to the extent possible, the economic difference between sets of estimated future cash flows. The standard provides some guidance in this regard.

Referring to Figure 1-2, note that the primary qualities laid out in *SFAC No. 8* are relevance and faithful representation (formerly referred to as reliability). Additional desirable characteristics include comparability, timeliness, and understandability.

The quality of *comparability* was very much at stake in FASB's decision in 2001 to eliminate the *pooling of interests* method for business combinations. This method was also argued to violate the *historical cost* principle as it essentially ignored the value of the consideration (stock) issued for the acquisition of another company. Of even greater concern was the potential for two nearly identical acquisitions to yield very different balance sheets, merely because one was accounted for under the pooling of interests method while the other used purchase accounting.

The issue of comparability plays a role in the more recent shift from the parent concept to the economic entity concept, as the former method valued a portion (the noncontrolling interest) of a given asset at prior book values and another portion (the controlling interest) of that same asset at exchange-date market value. The result was a piecemeal valuation of assets on the consolidated balance sheet.

Distinguishing between Earnings and Comprehensive Income

Opponents of the change to the economic entity view of consolidated financial statements may argue that the economic entity concept is less *conservative*, as it often revalues assets—in the case of a less than 100% acquisition—to a higher amount than has been reflected in an arm's length transaction by relying on the valuation *implied* by the purchase price. However, the constraint of conservatism is no longer included in FASB's constraints (*SFAC No. 8*).

Turning now to the elements of financial statements, see Illustration 1-4 for a summary of definitions. We might note that earnings is not defined as one of the elements included in *SFAC No. 6*. In fact, the FASB explicitly stated that it reserved the term earnings for possible use to designate a significant intermediate measure or component of comprehensive income. In *SFAC No. 5*, FASB states that "it is important to avoid focusing attention almost exclusively on the bottom line, earnings per share, or other highly simplified condensations." *SFAC No. 5* goes on to state that "statements of earnings and of comprehensive income together reflect the extent to which, and the ways in which, the equity of an entity increased or decreased from all sources other than transactions with owners during a period." The statement further expresses an expectation that the concept of earnings will

ILLUSTRATION 1-4

Definitions of Financial Statement Elements*

Assets. Probable future economic benefits obtained or controlled by a particular entity as a result of past transactions or events.

Liabilities. Probable future sacrifices of economic benefits arising from present obligations of a particular entity to transfer assets or provide services to other entities in the future as a result of past transactions or events.

Equity. Residual interest in the assets of an entity that remains after deducting its liabilities, or the claims of the owners of the entity's assets.

Investments by Owners. Increase in net assets of a particular enterprise resulting from transfers to it from other entities of something of value to obtain or increase ownership interests (equity) in it.

Distributions to Owners. Decrease in net assets of a particular enterprise resulting from transferring assets, rendering services, or incurring liabilities by the enterprise to its owners (dividends or Draws).

Comprehensive Income. Change in equity (net assets) of an entity during a period from transactions and other events and circumstances from nonowner sources, i.e., all changes in equity during a period except from investments by owners and distributions to owners.

Revenues. Inflows or other enhancements of assets of an entity or settlement of its liabilities (or a combinations of both) during a period from delivering or producing goods, rendering services, or other activities that constitute the entity's ongoing major or central operations.

Expenses. Outflows or other using up of assets or incurrences of liabilities (or a combination of both) during a period of delivering or producing goods, rendering services, or carrying out other activities that constitute the entity's ongoing major or central operations.

Gains. Increases in equity (net assets) from peripheral or incidental transactions of an entity and from all other transactions and other events and circumstances affecting the entity during a period except from revenues or investments by owners.

Losses. Decreases in equity (net assets) from peripheral or incidental transactions of an entity and from all other transactions and other events and circumstances affecting the entity during a period except from expenses or distributions to owners.

*"Elements of Financial Statements," *Statement of Financial Accounting Concepts No. 6* (Stamford, Conn.: FASB, December 1985), pp. ix and x.

evolve or develop over time. *SFAC No. 5* does, however, provide a working definition of earnings as follows:

Earnings is a measure of entity performance during a period. It measures the extent to which asset *inflows* (revenues and gains) associated with cash-to-cash cycles substantially completed during the period exceed asset *outflows* (expenses and losses) associated, directly or indirectly, with the same cycles.

In other words, earnings is essentially revenues and gains minus expenses and losses, with the exception of any losses or gains explicitly stated by FASB to bypass earnings and, instead, to be reported as a component of *other comprehensive income*.

What are examples of these "odd" gains and losses that bypass earnings under current GAAP? *SFAC No. 5* describes them as "principally certain holding gains or losses that are recognized in the period but are excluded from earnings such as some changes in market values of investments ... and foreign currency translation adjustments."

Not all changes in market values of investments are excluded from earnings, however. For example, the gains or losses recognized upon marking Trading Securities to market values *are* reported in earnings, while those on Available-for-Sale securities generally are not. Similarly, the gains or losses on foreign currency translation may or may not be reported in earnings, depending on whether the firm is using the temporal method (restatement) or the current method (translation) for its subsidiaries. In one case, the gain or loss appears in earnings. In the other, it appears as a component of *other comprehensive income*. This distinction is elaborated upon in Chapter 13, Translation of Financial Statements of Foreign Affiliates.

In short, these distinctions seem rather arbitrary and are thus, not surprisingly, confusing to students as well as to users of financial statements. The FASB's choices in this regard appear to be affected by: (a) the volatility that a particular gain or loss might introduce into earnings, and whether that volatility is reflective of true economic performance (in which case it should be reported in earnings) or is reflective of something else (in which case it is more likely to fall into other comprehensive income); and (b) the attitude of various constituents, or the effect of lobbying, which is in turn largely related to (a).

In this text, we use the term *net income* to refer to *earnings*, and we do not focus on comprehensive income in most chapters. In the absence of gains or losses designated to bypass earnings, earnings and comprehensive income are the same. However, if the firm has foreign subsidiaries or has available-for-sale securities or other investments that are being marked to market at the balance sheet date, the reader should be aware that current GAAP distinguishes between net current income and comprehensive income. Other items that may arise include certain gains or losses related to a firm's net pension liability; these too may bypass retained earnings and be reported instead as a component of *other comprehensive income*.

Be aware that any item which bypasses earnings will not appear in retained earnings (by definition, the accumulated earnings since incorporation minus dividends declared). Thus, other comprehensive income appears on the balance sheet as a separate component of stockholders' equity, labeled "Accumulated Other Comprehensive Income."

During June 2011, FASB voted to update FASB ASC topic 220 [Statement of Comprehensive Income], so that entities should present comprehensive income and its components either in a single *statement of comprehensive income* or as a consecutive statement immediately following the income statement. The single (combined) statement approach would still display net income as a subtotal, and continue on to display total comprehensive income on the same statement. Like most other current projects, this project reflects the joint efforts of the FASB and the IASB.



Asset Impairment and the Conceptual Framework

SEAC No. 5 provides the following guidance with respect to expenses and losses:

Consumption of benefit. Earnings are generally recognized when an entity's economic benefits are consumed in revenue earnings activities (or matched to the period incurred or allocated systematically); or

Loss or lack of benefit. Expenses or losses are recognized if it becomes evident that previously recognized future economic benefits of assets have been reduced or eliminated, or that liabilities have increased, without associated benefits.

In 2001, the FASB abandoned its long-held position that all intangible assets must be amortized over their useful lives, not to exceed 40 years. In the place of this position was born a new standard. If the asset has a finite life, amortize it, as before, over its useful life. However, if the life is deemed indefinite, then do not amortize the asset. Instead, review it periodically (at least once a year) for impairment or decreased value. The former approach (that of amortization) illustrates a *consumption or benefit* approach to measuring expenses while the impairment standard illustrates a *loss or lack of benefit* approach.

Another of the principles laid out by the FASB in *SFAC No. 5* is that of *matching* expenses to revenues (see Illustration 1-3; see also query on p. 33). The *consumption of benefit* approach emphasizes a more direct matching of expenses to revenues, while the *loss or lack of benefit* represents an example of those types of expenses that are most difficult, if not impossible, to match adequately to the generation of revenue. Thus, such losses as the impairment of goodwill reflect an attempt to recognize the loss of benefit in the period in which that loss is first identified.

Chapters 2 and 5 illustrate the impact of the impairment of goodwill (deemed to have an indefinite life) on the financial statements of the acquiring company and the consolidated entity, respectively.

FASB CODIFICATION (SOURCE OF GAAP)

On July 1, 2009, the Financial Accounting Standards Board (FASB) launched the *FASB Accounting Standards Codification* as the single source of authoritative non-governmental U.S. generally accepted accounting principles (GAAP). The Codification is effective for interim and annual periods ending after September 15, 2009. All existing accounting standards documents are superseded as described in FASB Statement No. 168, *The FASB Accounting Standards Codification and the Hierarchy of Generally Accepted Accounting Principles*. All other accounting literature not included in the Codification is nonauthoritative.⁴⁰

While not intended to change existing U.S. GAAP, the purpose of the Codification is to integrate existing accounting standards by multiple standard-setters within levels A through D of the former GAAP hierarchy. Cross-references are provided to link the Codification to the original standards. The Codification also contains *relevant* portions of authoritative content issued by the Securities and Exchange Commission as well as selected SEC staff interpretations and administrative guidelines.

It does not include SEC staff speeches, testimony, or Current Issues and Rule-making Projects (CIRPs), nor does it include pronouncements of the IASB. Nonetheless, one expectation of the Codification's implementation is that it will ease the convergence of U.S. GAAP and international standards (IFRS); and the material correlates at the topic and section levels to IFRS. As we move forward, future U.S. accounting standards will be issued in the form of an update to the appropriate topic or subtopic within the Codification.

⁴⁰ Rules and interpretive releases of the Securities and Exchange Commission (SEC) under authority of federal securities laws are also sources of authoritative GAAP for SEC registrants. In addition to the SEC's rules and interpretive releases, the SEC staff issues Staff Accounting Bulletins that represent practices followed by the staff in administering SEC disclosure requirements, and it utilizes SEC Staff Announcements and Observer comments made at Emerging Issues Task Force meetings to publicly announce its views on certain accounting issues for SEC registrants.

The Codification is intended to simplify the classification of existing and future standards by restructuring all authoritative U.S. GAAP (other than that for governmental entities) into one online database under a common referencing system. The codification is organized in a tiered structure consisting of a framework of topics, subtopics, sections, and paragraphs on each subject. The Codification does not codify all GAAP since the GAAP hierarchy also includes items such as practice, textbooks, articles, and other similar content. Thus instead of referring to specific FASB statements, the Codification will be referenced as ASC, which is the Accounting Standards Codification (ASC). In fact, the FASB will no longer issue statements (such as FAS No. 141), but will instead issue updates to the Codification. The updates will be referred to as ASU (or accounting standards update). The Codification replaces the GAAP hierarchy.

GAAP pronouncements are divided into 90 accounting topics and all topics are displayed using a consistent structure. In order to apply or search the Codification, one must understand its structure. References to the Codification contain four groupings of numbers. These four numbered items refer to (1) the topic, (2) the subtopic, (3) the section, and (4) the paragraph number for the appropriate accounting. Thus the code ASC 450-20-25-2 refers to topic 450, which is contingencies; subtopic 20, which is loss contingencies; section 25, which is recognition; and the 2 refers to the second paragraph.

Highest-level topics are organized in nine main areas, but are mainly grouped by financial statement. For instance, three general topics relate to the balance sheet (assets, liabilities, and equity) and two of the general topics relate to the income statement (revenues and expenses).

| <i>Groupings</i> | <i>General Topics</i> | <i>Topic Numbering</i> | <i>Number of Specific Topics in Each General Topic</i> |
|----------------------|---------------------------|------------------------|--|
| | General Principles | 105 | 1 |
| | Presentation | 200-299 | 15 |
| Balance Sheet Topics | Assets | 300-399 | 9 |
| | Liabilities | 400-499 | 9 |
| | Equity | 505 | 1 |
| Income Statement | Revenues | 605 | 1 |
| | Expenses | 700-799 | 8 |
| Other Topics | Broad Transactions | 800-899 | 14 |
| | Industry | 900-999 | 32 |
| | Total | | 90 |

- a. *General Principles (Topic 105)*. This topic establishes the *Accounting Standards Codification (Codification)* as the source of authoritative generally accepted accounting principles (GAAP). Rules and interpretive releases of the Securities and Exchange Commission (SEC) under authority of federal securities laws are also sources of authoritative GAAP for SEC registrants. Also, certain accounting standards allowed for the continued application of superseded accounting standards. Such grandfathered standards are typically not included in the Codification. Some of the grandfathered topics are listed in ASC 105-10-65-1.
- b. *Presentation (Topic Codes 205-299)*. There are 15 topics related to presentation of comparative financial statements. These topics do not address recognition,

measurement, and derecognition matters. Not all presentation issues will be found in ASC 200 topics. Within each general topic (topics 300 and higher), section 45 describes “other presentation matters” specific to that particular general topic. These can always be found in ASC XXX-YY-45-xx. For instance, ASC 330-10-45-2 describes the guidance on presenting contract costs of certain construction-type contracts. The topics included in presentation are as follows:

Presentation Topic (ASC 200 Topics)

| | |
|-----|--|
| 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 |

- c. *Financial Statement Accounts (Topic Codes 305–700)*. The Codification organizes topics in a financial statement order including Assets, Liabilities, Equity, Revenue, and Expenses. Topics include Receivables, Revenue Recognition, Inventory, and so on.

Balance Sheet Topics

Assets (ASC 300 Topics)

| | |
|-----|--|
| 305 | Cash and Cash Equivalents |
| 310 | Receivables |
| 320 | Investments—Debt and Equity Securities |
| 323 | Investments—Equity Method and Joint Ventures |
| 325 | Investments—Other |
| 330 | Inventory |
| 340 | Other Assets and Deferred Costs |
| 350 | Intangibles—Goodwill and Other |
| 360 | Property, Plant, and Equipment |

Liabilities (ASC 400 Topics)

| | |
|-----|--|
| 405 | Liabilities |
| 410 | Asset Retirement and Environmental Obligations |
| 420 | Exit or Disposal Cost Obligations |
| 430 | Deferred Revenue |
| 440 | Commitments |
| 450 | Contingencies |
| 460 | Guarantees |
| 470 | Debt |
| 480 | Distinguishing Liabilities from Equity |

Equity (ASC 500 Topics)

| | |
|-----|--------|
| 505 | Equity |
|-----|--------|

Income Statement Topics**Revenue (ASC 600 Topics)**

605 Revenue Recognition

Expenses (ASC 700 Topics)

705 Cost of Sales and Services

710 Compensations—General

712 Compensation—Nonretirement Postemployment Benefits

715 Compensation—Retirement Benefits

718 Compensation—Stock Compensation

720 Other Expenses

730 Research and Development

740 Income Taxes

- d. *Broad Transactions (Topic Codes 805–899)*. These topics relate to multiple financial statement accounts and are generally transaction-oriented. Topics include Business Combinations, Consolidations, Derivatives, Nonmonetary Transactions, Related Party Disclosures, Leases, and so on.

Broad Transactions (ASC 800 Topics)

805 Business Combinations

808 Collaborative Arrangements

810 Consolidation

815 Derivatives and Hedging

820 Fair Value Measurements and Disclosures

825 Financial Instruments

830 Foreign Currency Matters

835 Interest

840 Leases

845 Nonmonetary Transactions

850 Related Party Disclosures

852 Reorganizations

855 Subsequent Events

860 Transfers and Servicing

- e. *Industries (Topic Codes 905–999)*. These 32 topics relate to accounting that is unique to an industry or type of activity. Topics include Airlines, Entertainment, Extractive Activities, Financial Services, Non-for-Profit Entities, Software, Real Estate, and so on.

Industry Topics (ASC 900 Topics)

905 Agriculture

908 Airlines

910 Contractors—Construction

912 Contractors—Federal Government

915 Development Stage Entities

920 Entertainment—Broadcasters

922 Entertainment—Cable Television

924 Entertainment—Casinos

926 Entertainment—Films

928 Entertainment—Music

930 Extractive Activities—Mining

932 Extractive Activities—Oil and Gas

| | |
|-----|--|
| 940 | Financial Services—Broker and Dealers |
| 942 | Financial Services—Depository and Lending |
| 944 | Financial Services—Insurance |
| 946 | Financial Services—Investment Companies |
| 948 | Financial Services—Mortgage Banking |
| 950 | Financial Services—Title Plant |
| 952 | Franchisors |
| 954 | Health Care Entities |
| 958 | Not-for-Profit Entities |
| 960 | Plan Accounting—Defined Benefit Pension Plans |
| 962 | Plan Accounting—Defined Contribution Pension Plans |
| 965 | Plan Accounting—Health and Welfare Benefit Plans |
| 970 | Real Estate—General |
| 972 | Real Estate—Common Interest Realty Associations |
| 974 | Real Estate—Real Estate Investment Trusts |
| 976 | Real Estate—Retail Land |
| 978 | Real Estate—Time-Sharing Activities |
| 980 | Regulated Operations |
| 985 | Software |
| 995 | U.S. Steamship Entities |

Throughout this textbook, we reference the Codification by topic number only on occasion (i.e., FASB ASC 810 “Consolidations”) or in many instances using up to four groupings of numbers, which include the topic–subtopic–section–paragraph number (i.e., FASB ASC 810-20-25-4).

The Codification includes the following literature issued by various standard-setters that applies to all entities (other than governmental entities):

Standards Issued by Standard-Setters other than the SEC

- a. Financial Accounting Standards Board (FASB)
 1. Statements (FAS)
 2. Interpretations (FIN)
 3. Technical Bulletins (FTB)
 4. Staff Positions (FSP)
 5. Staff Implementation Guides (Q&A)
 6. Statement No. 138 Examples
- b. Emerging Issues Task Force (EITF)
 1. Abstracts
 2. Topic D
- c. Derivative Implementation Group (DIG) Issues
- d. Accounting Principles Board (APB) Opinions
- e. Accounting Research Bulletins (ARB)
- f. Accounting Interpretations (AIN)
- g. American Institute of Certified Public Accountants (AICPA)
 1. Statements of Position (SOP)
 2. Audit and Accounting Guides (AAG)—only incremental accounting guidance
 3. Practice Bulletins (PB), including the Notices to Practitioners elevated to Practice Bulletin status by Practice Bulletin 1
 4. Technical Inquiry Service (TIS)—only for Software Revenue Recognition

Standards issued by the SEC

To increase the utility of the Codification for public companies, relevant portions of authoritative content issued by the SEC and selected SEC staff interpretations and administrative guidance have been included for reference in the Codification, such as:

- a. Regulation S-X (SX)
- b. Financial Reporting Releases (FRR)/Accounting Series Releases (ASR)
- c. Interpretive Releases (IR)
- d. SEC Staff Guidance in
 1. Staff Accounting Bulletins (SAB)
 2. EITF Topic D and SEC Staff Observer comments

Changes to GAAP: Updating the FASB Standards

Updates to the Codification are called *Accounting Standards Updates* and are referenced as ASU YYYY-xx, where the *Ys* indicate the year the update was approved, and *xx* represents the number of the update for that year. For instance, ASU 2010-29 is the 29th update to the standards issued in 2010. Updates, by themselves, are not authoritative, but serve to update the Codification, provide background information, and provide the basis for the conclusions on the change. See Appendix ASC at the back of this book for more detail on researching the Codification.

SUMMARY

1. *Describe historical trends in types of business combinations.* Horizontal integration involving the combination of companies within the same industry was popular from 1880 to 1904. Vertical integration involving the combination of a company with its customers or suppliers became more prevalent from 1905 through 1930. The period beginning after World War II has been called merger mania. From the 1950s through the 1970s, conglomerate mergers between companies in different industries occurred in the face of antitrust regulation restricting combinations within a particular industry. A relaxation of antitrust regulation in the 1980s and the emergence of high-yield junk bonds led to a number of strategic acquisitions claiming to benefit from operating synergies. High stock prices in the 1990s created a wealth of mergers using stock as the medium of exchange.
2. *Identify the major reasons firms combine.* Firms combine to achieve growth goals or mandates, to obtain operating synergies, to compete more effectively in the international marketplace, to take advantage of tax laws in some cases, and to diversify or alternatively to eliminate competition.
3. *Identify the factors that managers should consider in exercising due diligence in business combinations.* Managers should be aware of unrecorded liabilities; take care in interpreting percentages quoted by the selling company; examine the impact on earnings from allocated expenses, changes in LIFO reserves and inventory levels, and product sales; note any nonrecurring items, changes in estimates, accruals, or methods; and be careful of CEO egos. In Appendix A, we provide a structured ratio approach using ratios to help the user find the target's strengths and weaknesses.
4. *Identify defensive tactics used to attempt to block business combinations.* Defensive tactics employed by target companies to avoid potential takeover include poison pills, greenmail, white knights or white squires, pac-man defense, selling the crown jewels, and leveraged buyouts.
5. *Distinguish between an asset and a stock acquisition.* An asset acquisition involves the purchase of all of the acquired company's net assets, whereas a stock acquisition involves the attainment of control via purchase of a controlling interest in the stock of the acquired company.

6. *Indicate the factors used to determine the price and the method of payment for a business combination.* Factors to be considered include the effect the acquisition is expected to have on future earnings performance, referred to as dilution or accretion, and the value of the firm's identifiable net assets as well as the estimated value of its implied goodwill. The method of payment is affected by the liquidity position of the purchasing firm, the willingness of the sellers to accept alternative forms of financing (stock, debt, cash, or a combination), and tax issues.
7. *Calculate an estimate of the value of goodwill to be included in an offering price by discounting expected future excess earnings over some period of years.* Identify a normal rate of return for firms similar to the company being targeted. Apply the rate of return to the level of identifiable assets (or net assets) of the target to approximate what the "normal" firm in this industry might generate with the same level of resources (normal earnings). Estimate the expected future earnings of the target. Subtract the normal earnings from the expected target earnings. The difference is "excess earnings." Assume an appropriate time period and a discount rate to calculate the discounted value of the excess earnings, or the estimated goodwill.
8. *Describe the two alternative views of consolidated financial statements: the economic entity and the parent company concepts.* Under the parent company concept, the consolidated financial statements reflect the stockholders' interests in the parent, plus their undivided interests in the net assets of the parent's subsidiaries. Thus the focus is on the interests of the parent's shareholders. In contrast, the economic entity concept emphasizes control of the whole by a single management. As a result, under this concept, consolidated financial statements are intended to provide information about a group of legal entities—a parent company and its subsidiaries—operating as a single unit.
9. *List and discuss each of the Statements of Financial Accounting Concepts (SFAC).* SFAC No. 3 (replaced by SFAC No. 6): Elements of Financial Statements of Business Enterprises. SFAC No. 4: Objectives of Financial Reporting by Nonbusiness Organizations. SFAC No. 5: Recognition and Measurement in Financial Statements of Business Enterprises—recognizes principles, assumptions, and constraints of accounting. SFAC No. 6 (replaces SFAC No. 3): Elements of Financial Statements—provides definitions of the components of financial statements. SFAC No. 7: Using Cash Flow Information and Present Value in Accounting Measurements—provides some guidance for these challenging measures. SFAC No. 8: Objectives of General Purpose Financial Reporting and Qualitative Characteristics of Useful Financial Information—discusses that the objective is to provide information that is useful for decision making by present and potential investors and creditors. The qualitative characteristics of useful financial information identify the types of information likely to be useful to the existing and potential investors, lenders, and other creditors for making decisions about the reporting entity.
10. *Describe some of the current joint projects of the FASB and the International Accounting Standards Board (IASB), and their primary objectives.* Among the current joint projects of the FASB and the International Accounting Standards Board (IASB) are projects on consolidations, on the conceptual framework, leases, and on financial presentation. Objectives include the development of standards that are principles based, internally consistent, and internationally converged; for the standards to be clearly based on consistent principles that are rooted in fundamental concepts rather than a collection of conventions; for the body of standards taken as a whole, as well as the application of those standards, to be based on a sound, comprehensive, and internally consistent framework; and convergence of the standards of the two Boards.

APPENDIX

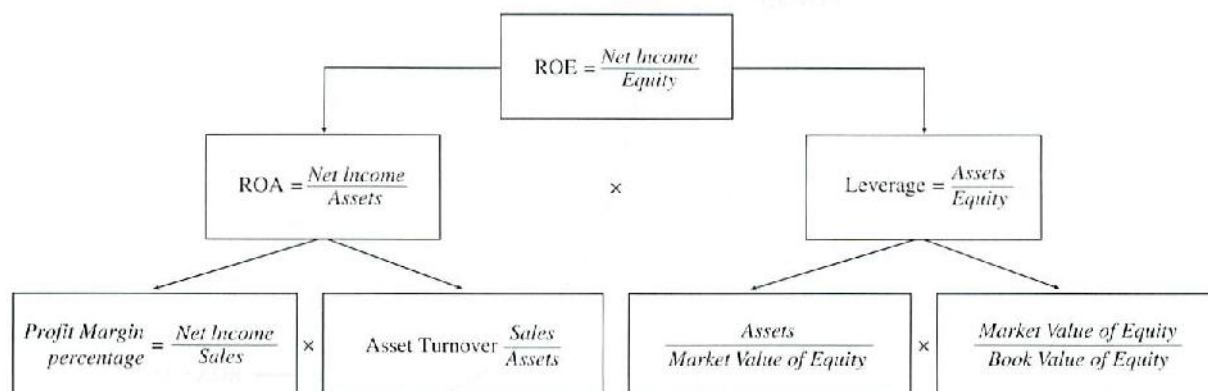
Evaluating Firm Performance

In this appendix, we provide a structured approach to evaluating firm performance. This approach can be used for many purposes. For example, it might be used to evaluate the potential performance of a proposed or completed merger. It might also be used as an analytical tool applied by auditors to evaluate the performance of an existing client. Individuals could use the approach as an initial step in determining investment opportunities. Depending on the objective of your analysis, a good starting point is to compute the return on equity (ROE) for the most recent years available. The structured approach decomposes this ratio into several commonly

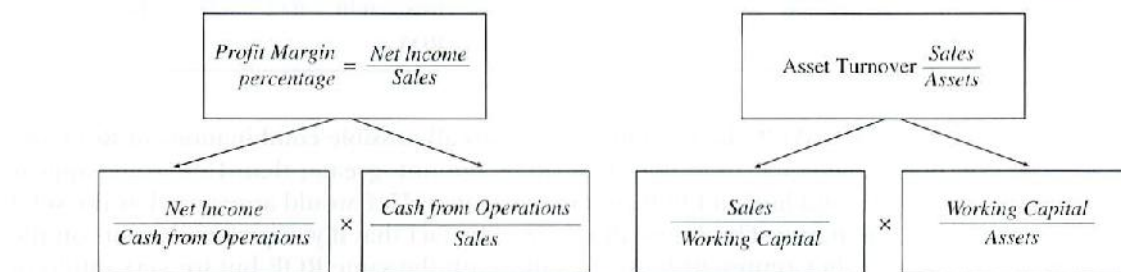
FIGURE A1-1

Structured Approach to Evaluate Firm Performance

Panel A: Decomposing Return on Equity (ROE)



Panel B: Decomposing the Profit Margin Percentage Using Cash from Operations and Decomposing the Asset Turnover Ratio Using Working Capital



used ratios, which are subsequently decomposed further. The overall approach is summarized in Figure A1-1.

In this textbook and in our structured approach, we use the following definition of ROE (more complex definitions of ROE can be applied with similar results):

$$\text{ROE} = \frac{\text{Net Income}}{\text{Equity}} \quad (1)$$

Next this ratio is decomposed into two components: Return on Assets (ROA) and a Leverage ratio. These ratios are defined as:

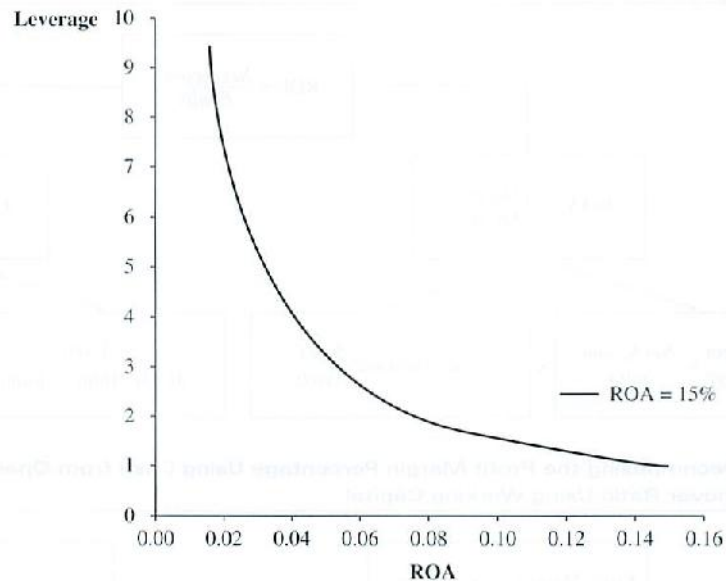
$$\text{ROA} = \frac{\text{Net Income}}{\text{Assets}} \quad (2)$$

$$\text{Leverage} = \frac{\text{Assets}}{\text{Equity}} = \frac{\text{Equity} + \text{Liabilities}}{\text{Equity}} \quad (3)$$

If you multiply these two ratios, Assets cancels out and you get ROE. Thus $\text{ROE} = \text{ROA} \times \text{Leverage}$. Assets divided by equity is considered a leverage ratio because Assets are equal to Liabilities plus Equity. Thus if the firm has more liabilities, this ratio is greater. The advantage of decomposing the ratios is that the ratio of interest can be graphed as a function of its decomposition. The graph of the decomposition of ROE is shown in Figure A1-2.

FIGURE A1-2

ROE (15%) by ROA and Leverage



In Figure A1-2, the solid line represents all possible combinations of ROA and leverage that equal an ROE of 15%. ROE amounts greater than 15% would appear above the solid line and ROE amounts less than 15% would appear below the solid line in the figure. This figure dramatizes the fact that if you pick two points on the solid line, they represent two companies with the same ROE but for very different reasons. A firm on the lower part of the solid line achieved its ROE with a high ROA with low amounts of leverage. A firm on the upper portion of the solid line achieved its ROE by using more debt in the capital structure but earning a lower ROA.

ROA Decomposition

The next decomposition breaks down the ROA ratio. ROA is decomposed into two components: the Profit Margin Percentage and an Asset Turnover ratio. These ratios are defined as:

$$\text{Profit Margin Percentage} = \frac{\text{Net Income}}{\text{Sales}} \quad (4)$$

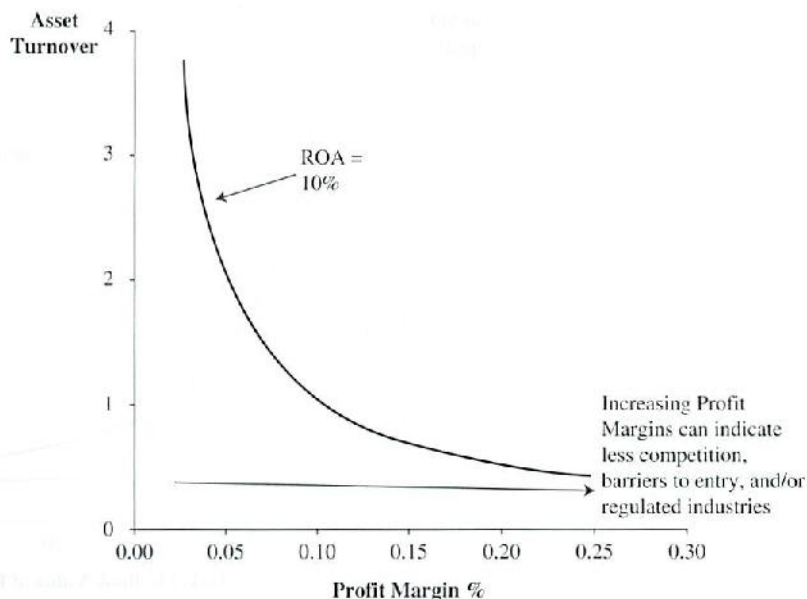
$$\text{Asset Turnover} = \frac{\text{Sales}}{\text{Assets}} \quad (5)$$

Again note that if you multiply these two ratios, Sales cancels out and you obtain the ROA ratio (ROA = Profit Margin \times Asset Turnover). The graph of the decomposition of ROA is shown in Figure A1-3.

In Figure A1-3, the solid line represents all possible combinations of the Asset Turnover ratio and Profit Margin percentage that equal an ROA of 10%. ROA amounts greater than 10% would appear above the solid line and ROA amounts less than 10% would appear below the solid line in the figure. Thus, if you pick two widely spaced points on the solid line, they would represent two companies with the

FIGURE A1-3

ROA (10%) by Profit Margin % and Asset Turnover



same ROA but for very different reasons. A firm on the lower part of the solid line achieved its ROA with a high profit margin but without generating a lot of revenues per dollar of assets. A firm on the upper portion of the solid line achieved its ROA by generating more sales per dollar of assets invested while earning a lower profit margin. As noted in the figure, a higher profit margin may indicate a less competitive industry. Alternatively, it might indicate high profit margins resulting from barriers to entry in that industry, such as a very capital-intensive industry. Higher profit margins could be due to regulatory constraints that prevent other firms from entering the market.

Decomposing Leverage

The next decomposition breaks down the leverage ratio. Interpreting leverage goes beyond relying on book value to debt ratios. In measuring the level of debt it is important to consider the market value of the firm's equity. Therefore, leverage is decomposed into two components: the Asset to Market Value of Equity and the Market Value of Equity to Book Value of Equity (market to book ratio). These ratios are defined as:

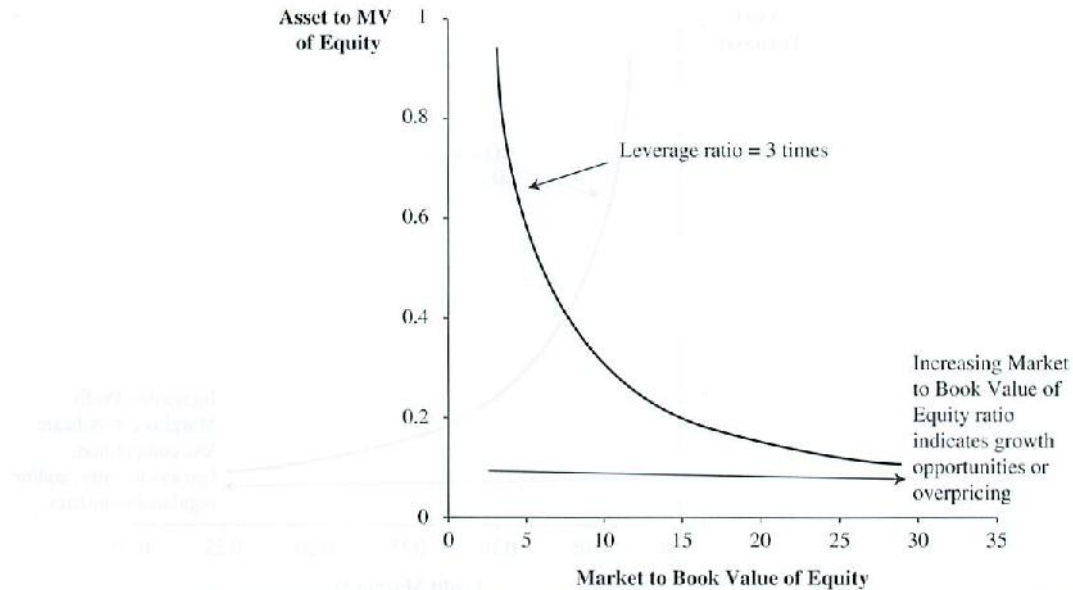
$$\text{Asset to Market Value Percentage} = \frac{\text{Assets}}{\text{Market Value of Equity}} \quad (6)$$

$$\text{Market to Book Ratio} = \frac{\text{Market Value of Equity}}{\text{Book Value of Equity}} \quad (7)$$

Again note that if you multiply these two ratios, Market Value cancels out and you obtain the leverage ratio (Leverage = Asset to Market Value Percentage \times Market to Book Ratio). The graph of the decomposition of leverage is shown in Figure A1-4.

FIGURE A1-4

Leverage as Function of Asset/MVE and Market to Book Value of Equity



Increasing market to book ratios often indicates increased growth opportunities for the firm, but could alternatively indicate overpricing. Thus, care must be taken in evaluating changes in these ratios.

Decomposing the Profit Margin and the Asset Turnover Ratios

Because the income statement is prepared on an accrual basis, further analysis is needed to incorporate the firm's cash flow position. This decomposition examines the size of the firm's accruals and whether they increase or decrease a firm's earnings. Also, the decomposition takes into account the amount of cash from operations (CFO) that is generated by the reported level of revenues. The profit margin is decomposed into two components: Net Income to Cash from Operations and Cash from Operations to Total Revenues. These ratios are defined as:

$$\text{Asset Net Income to Cash from Operations} = \frac{\text{Net Income}}{\text{Cash from Operations}} \quad (8)$$

$$\text{Cash from Operations to Revenues} = \frac{\text{Cash from Operations}}{\text{Revenues}} \quad (9)$$

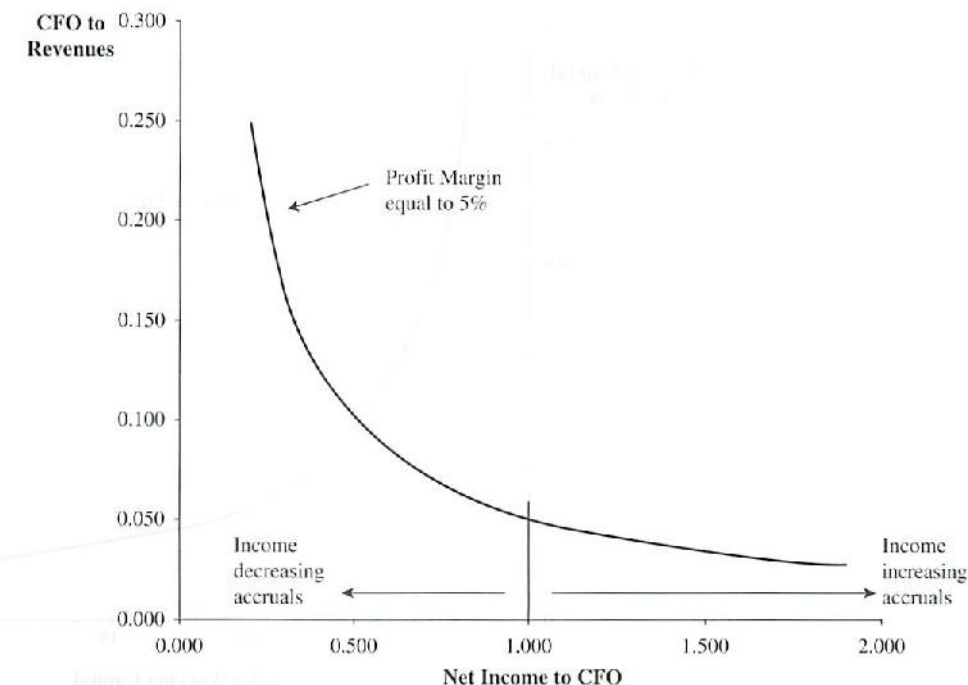
The asset turnover ratio is decomposed using the firm's working capital (current assets less current liabilities). Working capital measures the firm's liquidity; changes in working capital might indicate growth or alternatively could be a precursor to liquidity problems if the firm is struggling to sell its inventories or to collect its receivables, for example. The decomposition of the asset turnover ratio follows:

$$\text{Sales to Working Capital} = \frac{\text{Sales}}{\text{Working Capital}} \quad (10)$$

$$\text{Working Capital to Assets} = \frac{\text{Working Capital}}{\text{Assets}} \quad (11)$$

FIGURE A1-5

Profit Margin (5%) Decomposition



The graph for the profit margin decomposition is shown in Figure A1-5. The solid line represents all the possible combinations of net income to CFO and CFO to revenues that result in a profit margin of 5%. The line representing higher profit margins would be located above the line and lower profit margins would be represented below the line. The graph provides insight into the accrual process. Consider the case where net income equals CFO (see the vertical line at 1.0). Points above 1.0 represent situations where accruals increase earnings and points below 1.0 represent cases where accruals decrease earnings. Thus if the firm's last three profit margin observations plot very close to the vertical line at net income to CFO of 1.0, this implies that the overall timing of the revenues and expenses reported on the income statement are very close to the overall timing of the cash collections and cash payments. Income increasing accruals might signal future cash from operations, while income decreasing accruals would be likely to indicate lower future cash flows.

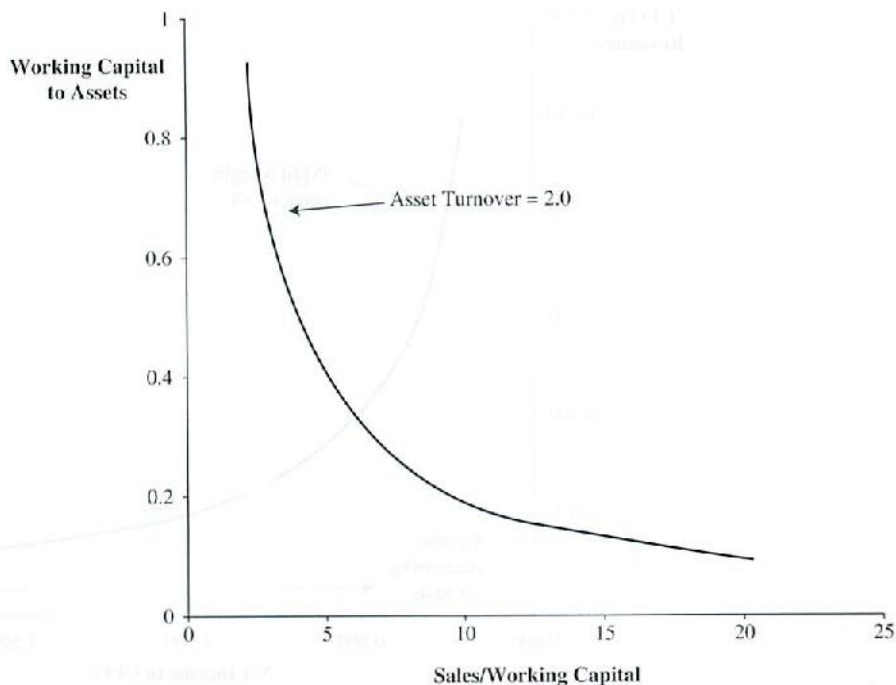
Figure A1-6 provides the graph of the decomposition of the asset turnover ratio. Clearly, if the firm can generate more revenues with lower working capital or lower assets, the asset turnover will increase.

Other Important Ratios

While the structured approach is a good start to financial analysis, it is not comprehensive. For instance, a common-size income statement is a great tool for analyzing various margins (such as the gross margin or operating margin) and locating areas of the income statement where certain expenses are growing faster than revenues. Also, there are other groupings of ratios that bear mention. By *groupings*, we mean

FIGURE A1-6

Asset Turnover (=2.0) Breakdown



that these ratios should be considered jointly rather than individually. For instance, consider the following three ratios:

1. Gross margin percentage (sales less cost of goods sold divided by sales)
2. Receivables turnover (sales divided by receivables)
3. Inventory turnover (cost of goods sold divided by inventory)

Turnover ratios are useful because they compare an income statement number and a balance sheet number (the name of the turnover ratio always defines the item in the denominator of the ratio). The gross margin ratio might indicate that sales grew faster than cost of goods sold, while a decrease in the inventory turnover may provide a warning that the firm could have over-purchased inventory.

Two final ratios to consider in your evaluation are:

1. Long-term debt to assets
2. Cash interest coverage ratio (cash from operations plus cash interest and cash taxes divided by cash interest paid)

The first ratio measures the amount of debt included in the capital structure, while the second ratio provides a measure of the firm's ability to meet the cash interest payment.

Note that the appendices on Researching the Codification (Appendix ASC) and presenting present value tables (Appendix PV) are located at the back of this book.

TEST
YOUR KNOWLEDGE
SOLUTIONS

1.1

1. a. poison pill
b. leveraged buyout (LBO)
c. white knight
2. d
3. d

QUESTIONS

- LO2 1. Distinguish between internal and external expansion of a firm.
- LO2 2. List four advantages of a business combination as compared to internal expansion.
- LO1 3. What is the primary legal constraint on business combinations? Why does such a constraint exist?
- LO2 4. Business combinations may be classified into three types based upon the relationships among the combining entities (e.g., combinations with suppliers, customers, competitors, etc.). Identify and define these types.
- LO5 5. Distinguish among a statutory merger, a statutory consolidation, and a stock acquisition.
- LO4 6. Define a tender offer and describe its use.
- LO6 7. When stock is exchanged for stock in a business combination, how is the stock exchange ratio generally expressed?
- LO4 8. Define some defensive measures used by target firms to avoid a takeover. Are these measures beneficial for shareholders?
- LO5 9. Explain the potential advantages of a stock acquisition over an asset acquisition.
- LO6 10. Explain the difference between an accretive and a dilutive acquisition.
- LO8 11. Describe the difference between the economic entity concept and the parent company concept approaches to the reporting of subsidiary assets and liabilities in the consolidated financial statements on the date of the acquisition.
- LO8 12. Contrast the consolidated effects of the parent company concept and the economic entity concept in terms of:
 - (a) The treatment of noncontrolling interests.
 - (b) The elimination of intercompany profits.
 - (c) The valuation of subsidiary net assets in the consolidated financial statements.
 - (d) The definition of consolidated net income.
- LO8 13. Under the economic entity concept, the net assets of the subsidiary are included in the consolidated financial statements at the total fair value that is implied by the price paid by the parent company for its controlling interest. What practical or conceptual problems do you see in this approach to valuation?
- LO9 14. Is the economic entity or the parent concept more consistent with the principles addressed in the FASB's conceptual framework? Explain your answer.
- LO9 15. How does the FASB's conceptual framework influence the development of new standards?
- LO9 16. What is the difference between net income, or earnings, and comprehensive income?

Business Ethics

From 1999 to 2001, Tyco's revenue grew approximately 24% and it acquired over 700 companies. It was widely rumored that Tyco executives aggressively managed the performance of the companies that they acquired by suggesting that before the acquisition, they should accelerate the payment of liabilities, delay recording the collections of revenue, and increase the estimated amounts in reserve accounts.

1. What effect does each of the three items have on the reported net income of the acquired company before the acquisition and on the reported net income of the combined company in the first year of the acquisition and future years?
2. What effect does each of the three items have on the cash from operations of the acquired company before the acquisition and on the cash from operations of the combined company in the first year of the acquisition and future years?
3. If you are the manager of the acquired company, how do you respond to these suggestions?
4. Assume that all three items can be managed within the rules provided by GAAP but would be regarded by many as pushing the limits of GAAP. Is there an ethical issue? Describe your position as: (A) an accountant for the target company and (B) as an accountant for Tyco.

ANALYZING FINANCIAL STATEMENTS

AFSI-1

Kraft and Cadbury PLC

On February 2, 2010, Cadbury's Board of Directors recommended that Cadbury's shareholders accept the terms of Kraft's final offer to acquire Cadbury. This ended one of the larger hostile takeovers that combined one company (Kraft) that reported using U.S. GAAP with an international company (Cadbury) that reported using IFRS as promulgated by the IASB and prepared financial statements in a foreign currency (the pound). The acquisition

allowed Kraft to increase its presence in the food processing industry in the developing world and to acquire a company specializing in confectionary products.

On February 2, 2010, Kraft acquired 71.73% of Cadbury's shares for \$13.1 billion. Incremental interest costs for Kraft to finance the deal are estimated to be approximately \$500 million (based on borrowing of \$9.5 billion). This interest cost is expected to decrease over time. Cadbury earned approximately \$428 million in income (exchange rate adjusted) for 2009. One issue that merging companies always face when another company is acquired is whether the merger will be accretive or dilutive in the early years after the acquisition.

- (1) Discuss some of the factors that should be considered in analyzing the impact of this merger on the income statement for the next few years.
- (2) Discuss the pros and cons that Kraft might have weighed in choosing the medium of exchange to consummate the acquisition. Do you think they made the right decision? If possible, use figures to support your answer.
- (3) In addition to the factors mentioned above, there are sometimes factors that cannot be quantified that enter into acquisition decisions. What do you suppose these might be in the case of Kraft's merger with Cadbury?
- (4) This acquisition is complicated by the lack of consistency between the two companies' methods of accounting and currency. Discuss the impact that these issues are likely to have on the merged company in the years following the acquisition.

AFS1-2

AFS1-2 Kraft Acquires Cadbury PLC

The following information from the financial statements of Kraft Foods and Cadbury PLC is available for the three years prior to their merger. Evaluate the performance of each company leading up to the year of the acquisition (2010). Note that Cadbury's financial statements are in millions of pounds, while Kraft's statements are in millions of dollars.

| <i>Kraft Foods (\$ millions)</i> | <i>2007</i> | <i>2008</i> | <i>2009</i> |
|--|-------------|-------------|-------------|
| Balance Sheet | | | |
| Assets | 67,993 | 63,173 | 66,714 |
| Total Liabilities | 40,698 | 40,817 | 40,742 |
| Stockholders' Equity | 27,295 | 22,356 | 25,972 |
| Selected Balance Sheet items | | | |
| Market value of equity | 50,480 | 48,110 | 40,111 |
| Current Assets | 10,737 | 9,917 | 12,454 |
| Current Liabilities | 17,086 | 11,044 | 11,491 |
| Accounts Receivable | 5,197 | 4,704 | 5,197 |
| Inventory | 4,096 | 3,881 | 3,775 |
| Long-term Debt | 13,624 | 19,354 | 18,537 |
| Retained Earnings | 12,209 | 13,440 | 14,636 |
| Income Statement | | | |
| Total Revenues | 37,241 | 40,492 | 38,754 |
| Cost of Goods Sold | 24,651 | 27,164 | 24,819 |
| Gross Margin | 12,590 | 13,328 | 13,935 |
| Income continuing operations | 2,590 | 1,678 | 2,810 |
| Net income | 2,590 | 2,884 | 3,021 |
| Selected Income Statement items | | | |
| Interest Expense | 604 | 1,240 | 1,237 |
| Tax Expense | 1,137 | 658 | 1,136 |

| Statement of Cash Flows | | | |
|--|-------------|-------------|-------------|
| Cash from Operations (CFO) | 3,571 | 4,141 | 5,084 |
| Cash interest paid | 628 | 968 | 1,308 |
| Cash taxes paid | 1,366 | 964 | 1,025 |
| Cadbury (£ millions) | 2007 | 2008 | 2009 |
| Balance Sheet | | | |
| Assets | 11,338 | 8,895 | 8,129 |
| Total Liabilities | 7,165 | 5,361 | 4,607 |
| Stockholders' Equity | 4,173 | 3,534 | 3,522 |
| Selected Balance Sheet items | | | |
| Market value of equity | 9,581 | 8,241 | 12,266 |
| Current Assets | 2,600 | 2,635 | 2,125 |
| Current Liabilities | 4,614 | 3,388 | 2,434 |
| Accounts Receivable | 1,197 | 1,067 | 978 |
| Inventory | 821 | 767 | 748 |
| Long-term Debt | 1,120 | 1,194 | 1,349 |
| Retained Earnings | 2,677 | 2,498 | 3,502 |
| Income Statement | | | |
| Total Revenues | 4,699 | 5,384 | 5,975 |
| Cost of Goods Sold | 5,504 | 2,870 | 3,210 |
| Gross Margin | 2,195 | 2,514 | 2,765 |
| Income continuing operations | 149 | 370 | 275 |
| Net income | 405 | 364 | 509 |
| Selected Income Statement items | | | |
| Interest Expense | 88 | 50 | 172 |
| Tax Expense | 105 | 30 | 103 |
| Statement of Cash Flows | | | |
| Cash from Operations (CFO) | 812 | 469 | 523 |
| Cash interest paid | 193 | 165 | 122 |
| Cash taxes paid | 235 | 153 | 163 |

Required:

- Use the method described in Appendix A to evaluate the health of the target company, and point out any trends that might have been worrisome to Kraft. Also indicate any strengths in the firm's performance.
- Use the method described in Appendix A to evaluate the health of Kraft Foods, and point out any positive or negative trends.

EXERCISES**EXERCISE 1-1 Estimating Goodwill and Potential Offering Price** LO7

Plantation Homes Company is considering the acquisition of Condominiums, Inc. early in 2008. To assess the amount it might be willing to pay, Plantation Homes makes the following computations and assumptions.

- Condominiums, Inc. has identifiable assets with a total fair value of \$15,000,000 and liabilities of \$8,800,000. The assets include office equipment with a fair value approximating book value, buildings with a fair value 30% higher than book value, and land with a fair value 75% higher than book value. The remaining lives of the assets are deemed to be approximately equal to those used by Condominiums, Inc.

- B. Condominiums, Inc.'s pretax incomes for the years 2005 through 2007 were \$1,200,000, \$1,500,000, and \$950,000, respectively. Plantation Homes believes that an average of these earnings represents a fair estimate of annual earnings for the indefinite future. However, it may need to consider adjustments to the following items included in pretax earnings:

| | |
|---------------------------------------|---------|
| Depreciation on buildings (each year) | 960,000 |
| Depreciation on equipment (each year) | 50,000 |
| Extraordinary loss (year 2007) | 300,000 |
| Sales commissions (each year) | 250,000 |

- C. The normal rate of return on net assets for the industry is 15%.

Required:

- A. Assume further that Plantation Homes feels that it must earn a 25% return on its investment and that goodwill is determined by capitalizing excess earnings. Based on these assumptions, calculate a reasonable offering price for Condominiums, Inc. Indicate how much of the price consists of goodwill. Ignore tax effects.
- B. Assume that Plantation Homes feels that it must earn a 15% return on its investment, but that average excess earnings are to be capitalized for three years only. Based on these assumptions, calculate a reasonable offering price for Condominiums, Inc. Indicate how much of the price consists of goodwill. Ignore tax effects.

EXERCISE 1-2 Estimating Goodwill and Valuation **LO7**

Alpha Company is considering the purchase of Beta Company. Alpha has collected the following data about Beta:

| | <i>Beta Company Book Values</i> | <i>Estimated Market Values</i> |
|---------------------------|-------------------------------------|------------------------------------|
| Total identifiable assets | \$585,000 | \$750,000 |
| Total liabilities | 320,000 | 320,000 |
| Owners' equity | <u>\$265,000</u> | |

Cumulative total net cash earnings for the past five years of \$850,000 includes extraordinary cash gains of \$67,000 and nonrecurring cash losses of \$48,000.

Alpha Company expects a return on its investment of 15%. Assume that Alpha prefers to use cash earnings rather than accrual-based earnings to estimate its offering price, and that it estimates the total valuation of Beta to be equal to the present value of cash-based earnings (rather than excess earnings) discounted over five years. (Goodwill is then computed as the amount implied by the excess of the total valuation over the identifiable net assets valuation.)

Required:

- A. Compute (a) an offering price based on the information above that Alpha might be willing to pay, and (b) the amount of goodwill included in that price.
- B. Compute the amount of goodwill actually recorded, assuming the negotiations result in a final purchase price of \$625,000 cash.

EXERCISE 1-3 Estimated and Actual Goodwill **LO7**

Passion Company is trying to decide whether or not to acquire Desiree Inc. The following balance sheet for Desiree Inc. provides information about book values. Estimated market values are also listed, based upon Passion Company's appraisals.

| | <i>Desiree Inc.</i> Book Values | <i>Desiree Inc.</i> Market Values |
|-----------------------------------|------------------------------------|--------------------------------------|
| Current assets | \$260,000 | \$ 260,000 |
| Property, plant & equipment (net) | 650,000 | 740,000 |
| Total assets | <u>\$910,000</u> | <u>\$1,000,000</u> |
| Total liabilities | \$400,000 | \$ 400,000 |
| Common stock, \$10 par value | 160,000 | |
| Retained earnings | <u>350,000</u> | |
| Total liabilities and equities | <u>\$910,000</u> | |

Passion Company expects that Desiree will earn approximately \$150,000 per year in net income over the next five years. This income is higher than the 12% annual return on tangible assets considered to be the industry "norm."

Required:

- A. Compute an estimation of goodwill based on the information above that Passion might be willing to pay (include in its purchase price), under each of the following additional assumptions:
- (1) Passion is willing to pay for *excess earnings* for an *expected life of five years* (undiscounted).
 - (2) Passion is willing to pay for *excess earnings* for an *expected life of five years*, which should be capitalized at the industry normal rate of return.
 - (3) *Excess earnings are expected to last indefinitely, but Passion demands a higher rate of return of 20% because of the risk involved.*
- B. Comment on the relative merits of the three alternatives in part (A) above.
- C. Determine the amount of goodwill to be recorded on the books if Passion pays \$800,000 cash and assumes Desiree's liabilities.

ASC Exercises: For all ASC Exercises indicate as part of your answer: the Codification topic, subtopic, section, and/or paragraph upon which your answer is based (unless otherwise specified). All ASC questions require access to the FASB Codification.^a

- ASC1-1 **Cross-Reference** The conditions determining whether a lease is classified as an operating lease or a capital lease were prescribed in *SSAS No. 13*, paragraph 7. Where is this located in this Codification?
- ASC1-2 **Cross-Reference** The rules defining the conditions to classify an item as extraordinary on the income statement were originally listed in *APB Opinion No. 30*, paragraph 20. Where is this information located in the Codification?
- ASC1-3 **Disclosure** Suppose a firm entered into a capital lease, debiting an asset account and crediting a lease liability account for \$150,000. Does this transaction need to be disclosed as part of the statement of cash flows? If so, where?
- ASC1-4 **General Principles** Accounting textbooks under the former GAAP hierarchy were considered level 4 authoritative. Where do accounting textbooks stand in the Codification?
- ASC1-5 **Presentation** How many years of comparative financial statements are required under current GAAP?
- ASC1-6 **Overview** Can the provisions of the Codification be ignored if the item is immaterial?

^a See Appendix ASC on Researching the FASB Codification at the back of the book for guidance in answering the ASC Exercises.