2

ACCOUNTING FOR BUSINESS COMBINATIONS

LEARNING OBJECTIVES

1. Describe the major changes in the accounting for business combinations passed by the FASB in December 2007, and the reasons for those changes.
2. Describe the two major changes in the accounting for business combinations approved by the FASB in 2001, as well as the reasons for those changes.
3. Discuss the goodwill impairment test, including its frequency, the steps laid out in the new standard, and some of the implementation problems.
4. Explain how acquisition expenses are reported.
5. Describe the use of pro forma statements in business combinations.
6. Describe the valuation of assets, including goodwill, and liabilities acquired in a business combination accounted for by the acquisition method.
7. Explain how contingent consideration affects the valuation of assets acquired in a business combination accounted for by the acquisition method.
8. Describe a leveraged buyout.
9. Describe the disclosure requirements according to current GAAP related to each business combination that takes place during a given year.
10. Describe at least one of the differences between U.S. GAAP and IFRS related o the accounting for business combinations.

HISTORICAL PERSPECTIVE ONBUSINESS COMBINATIONS

IN THE NEWS

In response to possible chanes to the tax code by the IRS, which could greatly alter how changes in the value of tangible assets affect a company's tax liability, Selva Ozelli, a CPA and internation tax expert, stated that intangibles are "the main drivers of economic value crea n and economic growth in American multinational companies...[and] contribut ignificantly to an enterprise's competitive advantage. They often have the potent to yield above-average profits, while physical and financial assets are rapidly coming commoditized."[1]

[1] *Accounting Today*, "New Reg d Change the Landscape for Intangibles," by Roger Russell, 9/26/05, p. 3.

LO1 FASB's two major changes for business combinations.

FASB shook up the accounting community in the area of business combinations in December of 2007 by releasing two new standards. The first, ***SFAS No. 141R***, "Business Combinations," completely replaced ***FASB Statement No. 141.*** This pronouncement supports the use of a single method in accounting for business combinations, and uses the term "acquisition method" in place of the previous term, "purchase method," to describe the preferred approach. Most of the primary conclusions reached in ***SFAS No. 141*** (and elaborated upon in the following paragraph) were carried forward without reconsideration. The differences addressed in the newer standard related to a number of criticisms that have haunted the accounting for business combinations for some time. These standards are now codified in FASB ASC topic 805 [Business Combinations].

One of the criticisms is that the standards of accounting for business combinations differ significantly between U.S. GAAP and International Financial Reporting Standards (IFRS). In 2002 the two principal standard setting boards, the FASB and the IASB (International Accounting Standards Board), agreed to reconsider the topic jointly with the objective of convergence, or finding a common and comprehensive standard that could be used both domestically and in cross-border situations. Nonetheless, the standards are not identical. Those differences are described at the end of this chapter.

IFRS

The objective of the change was to recommend a single method that should result in more comparable and transparent financial statements. The essence of the change is that the acquired business should be recognized at its fair value on the acquisition date rather than its cost, regardless of whether the acquirer purchases all or only a controlling percentage (even if the combination is achieved in stages). In the past, when a business combination was achieved in stages (for example, a company purchases 20% of another company at one date, purchases an additional 20% a number of years later, and then achieves control by purchasing 12% at a still later date), the cost amounts from prior purchases (which might have occurred decades earlier) were combined with current values to create an accumulated total that reflected a mix of fair values and old book values being carried forward. This combination of amounts has long been criticized as lacking consistency, understandability, and usefulness. **Under current GAAP the fair values of all assets and liabilities on the acquisition date, defined as the date the acquirer obtains control of the acquiree, are reflected in the financial statements.** This change has the potential to affect the timing and the structure of deals.

IN THE NEWS

The amendment to business combinations, put forward jointly by the International Accounting Standards Board (IASB) and U.S. Financial Accounting Standards Board (FASB), has its share of opponents. Various parties, including companies, analysts, accountants and regulatory bodies, tried to block the change, which they claimed was an effort by the standard setters to implement new rules rather than fine-tune the existing ones. The new standard places emphasis on fair values in a business combination, even in cases where less than 100% of the equity interests in the acquiree are purchased. Opponents state that the outcome of placing more goodwill on a company's financial statement is to produce artificial figures that fail to reflect the true value of a takeover transaction.[2]

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[2] *Finance Week,* "Analysis: New Merger Rules to Increase Scrutiny in Deal-Making," 11/16/05, p. 14.

CHANGES IN GAAP [ASC Topic 805] WITH SIGNIFICANT IMPLICATIONS FOR DEALS

Issue	*Prior GAAP*	*Current GAAP*
Measurement date for securities issued	Use a reasonable period of time before and after the terms are agreed to and announced.	Use the fair value on the acquisition date.
Acquisitions costs	Capitalize the costs.	Expense as incurred.
Acquisition of control but less than 100%	Minority interest is recorded at historical cost.	Non-controlling interest is recorded at fair value along with 100% of the goodwill.
In-process R&D	Included as part of purchase price, but then immediately expenses.	Included as part of purchase price, treated as an asset.
Negative goodwill	Reduction of certain noncurrent assets with the remained as extraordinary gain.	No reduction of assets is recorded, record as a gain on the income statement.
Contingent consideration	Record when determinable and reflect subsequent changes in the purchase price.	Record at fair value on the acquisition date with subsequent changes recorded on the income statement.
Business definition	A business is defined as a self-sustaining integrated set of activities and assets conducted and managed for the purpose of providing a return to investors. The definition would exclude early-stage development entities.	A business or a *group of assets* no longer must be self-sustaining. The business or group of assets must be capable of generating a revenue stream. This definition would include early-stage development entities.
Decreases in ownership interest	Include gains and losses on decreases in ownership interest in income.	Decreases in ownership (if control is still maintained) are capital transactions. Decreases in ownership accompanied by a loss of control result in a gain or loss. The gain or loss is realized on the portion of interest sold an unrealized on the equity interests retained.

The standards for business combinations now apply to business combinations involving only mutual entities, those achieved by contract alone, and the initial consolidation of variable interest entities (VIEs). Variable interest entities are discussed in Chapter 3.

A second standard, also issued on December 4, 2007, "Noncontrolling Interests in Consolidated Financial Statements," amended *Accounting Research Bulletin (ARB) No. 51* (now included in FASB ASC topic 810 [Consolidations]). This pronouncement established standards for the reporting of the noncontrolling interest when the acquirer obtains control without purchasing 100% of the acquiree. A noncontrolling (or minority) interest does not exist in net asset acquisitions, which are the focus of this chapter. Thus most of the discussion of this issue is deferred to Chapter 3.

Earlier Standards In a unanimous vote in 2001, the *Financial Accounting Standards Board (FASB)* reaffirmed a decision that had drawn strong opposition from businesses and had led some members of Congress to propose legislative intervention. But opposition softened when the Board voted to change the alternative method of accounting for mergers, purchase accounting, to make it less onerous. Companies had often tried to avoid 'purchase accounting' because it required them to add the intangible asset goodwill to their balance sheets and then write off the goodwill over 20 years or more, lowering profits. But the Board decided that it would no longer require, or even allow, the write-off of goodwill until the company concluded that its value was impaired. This could mean higher profits.[3]

RELATED CONCEPTS

Requiring one method for all acquisitions makes financial statements more *comparable* across firms than allowing two methods for similar events.

Historically, two distinct methods of accounting for business combinations were permitted in the United States: purchase and pooling of interests. Although the majority of mergers were accounted for by the purchase method, in cases where the stock of one company was being exchanged for all the assets or most of the stock (90% or more) of the other, firms sometimes went to great lengths to satisfy an elaborate set of pooling criteria laid out by the U.S. standard setters. Today all mergers in the United States must be accounted for by the acquisition (or purchase) method.

With the issuance of *SFAS No. 141*, "Business Combinations," [FASB ASC 805] and *SFAS No. 142*, "Goodwill and Other Intangible Assets," [FASB ASC 350] in June 2001, the FASB culminated a project on business combinations brought to its agenda in August 1996 to reconsider *APB Opinion No. 16*, "Business Combinations," and *APB Opinion No. 17*, "Intangible Assets." Although some companies' management and even analysts responded initially with rosy predictions that the earnings numbers would look a lot ***better*** for companies with large amounts of goodwill, less than a year later many of these same firms were writing off large chunks of goodwill under the new impairment rules.

LO2 FASB's two major changes of 2001.

In a pronouncement issued in June 2001, **the Board reaffirmed its proposal to prohibit the popular method referred to as the pooling of interests and decided that goodwill would no longer be amortized and would instead be tested periodically for impairment in a manner different from other assets.** Specifically, use of the pooling method has been prohibited for business combinations initiated since June 30, 2001. Goodwill acquired in a business combination completed since June 30, 2001, should not be amortized.

The Board included the following statements in justifying the changes: Analysts and other users of financial statements indicated that it was difficult to compare the financial results of entities because different methods of accounting for business combinations were used. Users of financial statements also indicated a need for better information about intangible assets because those assets are an increasingly important economic resource for many entities and are an increasing proportion of the assets acquired in many business combinations. Company managements indicated that the differences between the pooling and purchase methods of accounting for business combinations affected competition in markets for mergers and acquisitions.

As might be predicted, responses to the changes ranged from complaints that the FASB had "given away the store"[4] to praise that the combined changes would yield enhanced flexibility for businesses.

[3] *New York Times*, "Board Ends Method of Accounting for Mergers," by Floyd Norris, 1/25/01, p. C9.

[4] *WSJ*, "FASB Backs Down on Goodwill-Accounting Rules," 12/7/00, page A2.

Others, such as Morgan Stanley Dean Witter's Trevor Harris, argued from the onset that there should be no long-term effect on stock prices and that any initial price effect from the changed accounting standards was merely a momentum play.[5]

While fans of the standards regarding goodwill accounting applauded their flexibility, critics questioned whether the goodwill impairment test opens the door for manipulation of earnings via the timing of write-offs, and some suggested an increase in hostile activity.

Goodwill Impairment Test

LO3 Goodwill impairment assessment.

FASB ASC paragraph 350–20–35–18 requires that goodwill impairment be tested annually.[6] However, an update is expected in September 2011 that could potentially lessen the burden significantly.

IN THE NEWS

"The Board's decision today comes as a direct result of what we heard from private companies, which had expressed concerns about the cost and complexity of performing the goodwill impairment tests," states FASB member Daryl Buck. "The amendments approved by the Board address those concerns and will simplify the process for public and nonpublic entities alike." The amendments are effective for years beginning after December 15, 2011, with early adoption allowed.[7]

For purposes of the goodwill impairment test, all goodwill must be assigned to a reporting unit. Under the amendment, entities will first assess *qualitative* factors to determine whether it is more likely than not that the fair value of the reporting unit is less than its carrying amount. If so, then the entity must perform a two-step *quantitative* goodwill impairment test. In the *first step,* the reporting unit must determine if the carrying value is greater than zero. If the carrying amount of a reporting unit is zero or less, the second step is performed when it is more likely than not that a goodwill impairment exists. Circumstances that determine whether it is more likely than not would include unanticipated competition, loss of key personnel, an adverse action by a regulator, and so on. If the carrying amount of a reporting unit is greater than zero and its fair value *exceeds* its carrying amount, goodwill of the reporting unit is considered not impaired; thus, the second step of the impairment test is unnecessary. If the carrying amount of a reporting unit is greater than zero and its fair value is *less than* its carrying amount, goodwill of the reporting unit is considered impaired; thus, the second step of the impairment test is needed. In the *second step,* the carrying value of the goodwill is compared to its implied fair value. See Figure 2-1 for a visual illustration of this process.

IN THE NEWS

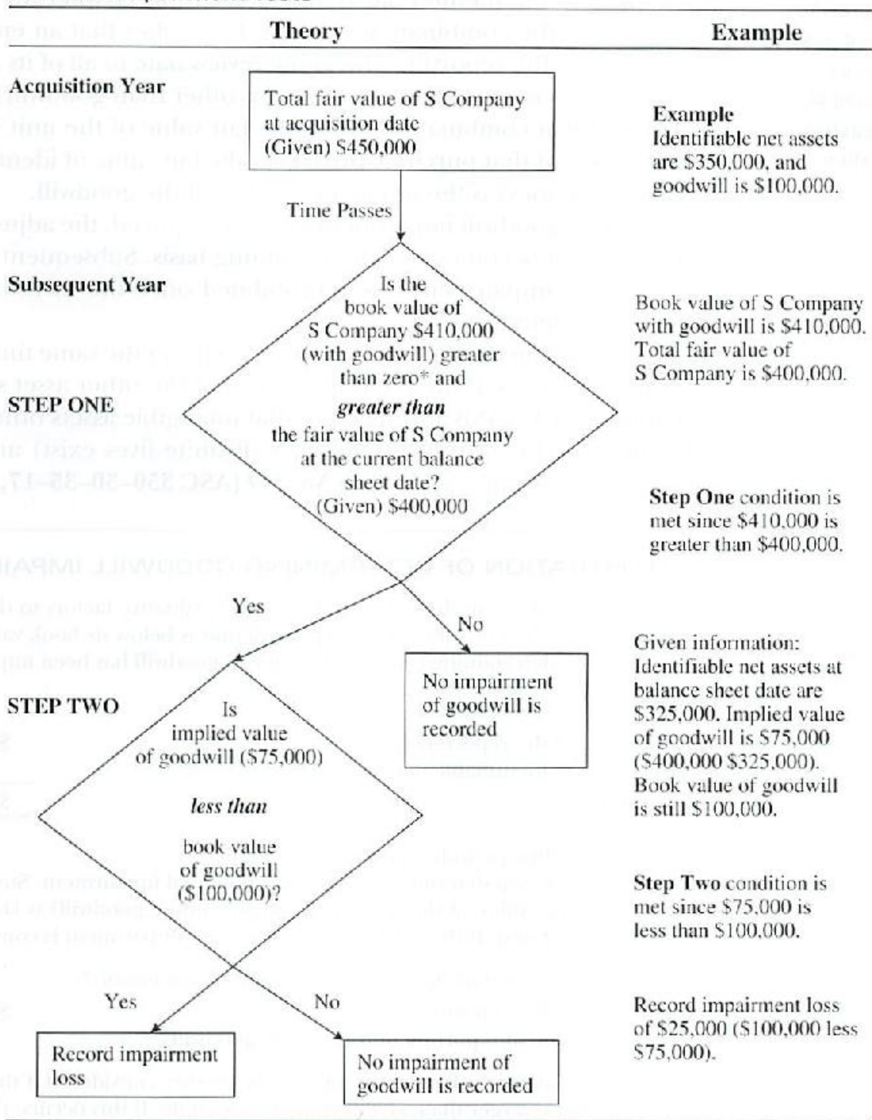
What is a reporting unit? A reporting unit is the level at which management reviews and assesses the operating segment's performance—in other words, discrete business lines or units that can be grouped by geography and can produce stand-alone financial statements (for example, four operating divisions reporting to the corporate parent). A company can use a reporting unit one level below the operating segment for impairment testing if components of an operating segment engage in business activities for which discrete financial information is available, have economic characteristics different from the other components of the operating segments, and are at the level at which goodwill benefits are realized.

[5] *WSJ,* "Goodwill Hunting: Accounting Change May Lift Profits, but Stock Prices May Not Follow Suit," by Jonathan Weil, 1/25/01, p. C1.

[6] Transitional rules for impairment of previously recognized goodwill allowed firms taking impairment losses on adoption to treat those items as below-the-line charges shown after extraordinary items on the income statement. This option, however, was not available in subsequent years.

[7] "FASB Approves Standard to Simplify Testing Goodwill for Impairment," FASB News Release, August 10, 2011, Norwalk, CT.

FIGURE 2-1
Goodwill Impairment Tests



*If the carrying value of the reporting unit is zero or less, the second step of the impairment test is performed to measure the amount of impairment loss, if any, when it is more likely than not that a goodwill impairment exists. See FASB ASC paragraph 350-20-35-30 for such circumstances.

How tough is it to establish a value for the reporting unit? Businesses may not like the impairment rules because of the difficulty they have determining the fair value of the segment. However, if the reporting unit is a whole company, the current stock price will represent fair value. Although many finance managers object that current trading price doesn't always reflect fair value, CPAs like this measure because it is objective and verifiable.[8]

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[8] *Journal of Accountancy*, "Say Goodbye to Pooling and Goodwill Amortization," by S. R. Moehrle and J. A. Reynolds-Moehrle, September 2001, p. 31.

RELATED CONCEPTS

Verifiability is specified in *SFAC No. 8* as an enhancing attribute of accounting information.

The calculation of the implied fair value of goodwill used in the impairment test is similar to the method illustrated later in this chapter for valuing the goodwill at the date of the combination. The FASB specifies that an entity should allocate the fair value of the reporting unit at the review date to all of its assets and liabilities (including unrecognized intangible assets other than goodwill) as if the unit had been acquired in a combination where the fair value of the unit was the purchase price. The excess of that purchase price over the fair value of identifiable net assets (assets minus liabilities) is the implied fair value of the goodwill.

After a goodwill impairment loss is recognized, the adjusted carrying amount of the goodwill becomes its new accounting basis. Subsequent reversal of a previously recognized impairment loss is prohibited once the measurement of that loss has been completed.

If an impairment test for goodwill occurs at the same time as an impairment test for any other asset, the FASB instructs that the other asset should be tested for impairment first. FASB also specifies that intangible assets other than goodwill should be amortized over their useful lives (if finite lives exist) and reviewed for impairment in accordance with ***SFAS No. 144*** **[ASC 350–30–35–17, 18].**

ILLUSTRATION OF DETERMINING GOODWILL IMPAIRMENT

As a preliminary test, the entity should assess qualitative factors to determine if it is *more likely than not* that the fair value of the reporting unit is below its book value. If it is, then there are two steps in determining whether the value of goodwill has been impaired. Assume:

On the date of acquisition:

Fair value of the reporting unit	$450,000
Fair value of identifiable net assets	350,000
Goodwill	$100,000

On the first periodic review date:

The first step determines if there is a potential impairment. Step two will be needed only if the carrying value of the reporting unit (including goodwill) is larger than the fair value of the reporting unit. If the carrying value is less, no impairment is considered.

Step One: Does potential impairment exist (i.e., is step two needed)?

Fair value of the reporting unit	$400,000
Carrying value of reporting unit (includes goodwill)	410,000

Potential goodwill impairment must be further considered if the carrying value of the reporting unit is larger than $400,000, in this example. If this occurs, then proceed to step two.

Step two determines the amount of the impairment (if any). In step two, the fair value of goodwill is determined by comparing the fair value of the reporting unit at the periodic review date to the fair value of the identifiable net assets at this time. (The difference is the implied value of goodwill on this date.)

Step Two: What is the amount of goodwill impairment (if any)?

Fair value of the reporting unit	$400,000
Fair value of identifiable net assets at review date	325,000
Fair value of goodwill (implied)	$ 75,000

Since the carrying value of goodwill is $100,000 and the remaining fair value of goodwill is $75,000, goodwill impairment of $25,000 must be reported.

Carrying value of goodwill	$100,000
Fair value of goodwill	75,000
Goodwill impairment loss	$ 25,000

Disclosures Mandated by FASB

FASB ASC paragraph 805–30–50–1 requires the following disclosures for goodwill:

RELATED CONCEPTS

***Full disclosure* suggests that all important aspects of acquisitions should be revealed to readers of the financial statements. This includes the reasons for subsequent impairment losses.**

1. The total amount of acquired goodwill and the amount expected to be deductible for tax purposes.
2. The amount of goodwill by reporting segment (if the acquiring firm is required to disclose segment information), unless not practicable.

FASB ASC paragraph 350–20–45–1 specifies the presentation of goodwill in the balance sheet and income statement (if impairment occurs) as follows:

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

In a period in which an impairment loss occurs, FASB ASC paragraph 350–20–45–2 mandates the following disclosures in the notes:

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

IN THE NEWS

CBS Corp. announced that it wrote down the goodwill value of its television and radio assets by $9.5 billion to $13.5 billion, resulting in a sizable fourth quarter loss. It is the second consecutive year CBS has taken a goodwill write-down under the accounting rule that requires an annual test for impairment of intangible assets. The most recent write-down is reflective of continued challenges and slow growth in the radio and broadcast television industries.[9]

LO9 New disclosure requirements for business combinations.

Other Required Disclosures FASB ASC paragraph 805–10–50–2 states that to meet its objectives, the acquirer should disclose pertinent information for each material business combination that takes place during the reporting period, to include the following:

- The name and a description of the acquiree.
- The acquisition date.
- The percentage of voting equity instruments acquired.
- The primary reasons for the business combination, including a description of the factors that contributed to the recognition of goodwill.

[9] *WSJ*, "CBS Posts $9.14 Billion Loss on Hefty Asset Write-Downs," Brooks Barnes, 2/23/06.

combination proposal, pro forma statements showing the effects of the proposal may be prepared for distribution to the stockholders of the constituents for their consideration prior to voting on the proposal. If the proposed combination involves the issue of new securities under *Securities and Exchange Commission (SEC)* rules, pro forma statements may be required as part of the registration statement.

When a pro forma statement is prepared, the tentative or hypothetical nature of the statement should be clearly indicated, generally by describing it as "pro forma" in the heading and including a description of the character of the transactions given effect to. Further description of any other adjustments should be clearly stated on the statement or in related notes. A pro forma balance sheet (based on data presented in Illustration 2-2) that might be prepared for use by the companies' stockholders is presented in Illustration 2-1. The normal procedure is to show the audited balance sheet as of a given date, individual adjustments for the proposed transaction, and resulting account balances.

Second, pro forma presentation is a valuable method of disclosing relevant information to stockholders and other users subsequent to the combination. Some types of pro forma presentation are required by FASB ASC subparagraph 805–10–50–2(h) if the combined enterprise is a public business enterprise.

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

1. Results of operations for the current year as though the companies had combined at the beginning of the year, unless the acquisition was at or near the beginning of the year.
2. Results of operations for the immediately preceding period as though the companies had combined at the beginning of that period if comparative financial statements are presented.

ILLUSTRATION 2-1

P Company Pro Forma Balance Sheet
Giving Effect to Proposed Issue of Common Stock for All the Net Assets of S Company January 1, 2012

Assets	*Audited Balance Sheet*	*Adjustment*	*Pro Forma Balance Sheet*
Cash and receivables	$ 250,000	$ 170,000	$ 420,000
Inventories	260,000	140,000	400,000
Land	600,000	400,000	1,000,000
Buildings & equipment	800,000	1,000,000	1,800,000
Accumulated depreciation	(300,000)		(300,000)
Goodwill	—0—	230,000	230,000
Total assets	$1,610,000		$3,550,000
Liabilities and Equity			
Current liabilities	$ 110,000	150,000	260,000
Bonds payable	—0—	350,000	350,000
Common stock	750,000	450,000	1,200,000
Other contributed capital	400,000	990,000	1,390,000
Retained earnings	350,000		350,000
Total equities	$1,610,000		$3,550,000

TEST YOUR KNOWLEDGE

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

2.1

Multiple Choice

1. Which of the following statements is *true* with respect to the accounting for business combinations under U.S. GAAP?
   a. Incomparability of financial statements under the previous rules permitting two distinct methods of accounting for business combinations (purchase and pooling) was corrected by making amortization of goodwill optional.
   b. Under the current standards, impairment of goodwill is not accounted for because it does not affect the actual profit of the company.
   c. The acquired business should be recognized at its fair value on the acquisition date, regardless of whether the acquirer purchases all or only a controlling percentage.
   d. Any goodwill acquired in previous acquisitions should continue to be amortized after the year 2001 for the continuity of the accounting practice.
2. Goodwill impairment exists only if the fair value of the business unit:
   a. Equals the carrying value of the reporting unit (including goodwill).
   b. Is greater than the carrying value of the reporting unit (including goodwill).
   c. Is less than the carrying value of the reporting unit (including goodwill).
   d. None of the above.
3. Which of the following is *incorrect*?
   a. Under acquisition accounting, direct acquisition costs are recorded by decreasing goodwill as a contra account.
   b. Under acquisition method accounting, indirect acquisition costs (such as expenses incurred by a firm's permanent M&A department) are expensed.
   c. Security issue costs, such as brokerage fees, reduce the Excess Paid In Capital account (i.e., are recorded as a debit to that account).
   d. Accounting and consulting fees incurred in a business combination are expenses under the current standards for acquisitions.

EXPLANATION AND ILLUSTRATION OF ACQUISITION ACCOUNTING

As the term implies, the acquisition method treats the combination as the acquisition of one or more companies by another. Four steps are required in accounting for a business combination:

1. Identify the acquirer.
2. Determine the acquisition date.
3. Measure the fair value of the acquiree.
4. Measure and recognize the assets acquired and liabilities assumed.

Bank of New York will swap its retail banking business for J.P. Morgan Chase's corporate trust unit plus $150 million in cash. The Bank of New York's retail and regional middle-market businesses were valued at $3.1 billion while J.P. Morgan Chase's corporate trust business was valued at $2.8 billion. The difference results in a net cash payment, after negotiations, to Bank of New York.[11]

Assets acquired by issuing shares of stock of the acquiring corporation are recorded at the fair values of the stock given or the assets received, whichever is more clearly evident. If the stock is actively traded, its quoted market price, after making allowance for market fluctuations, additional quantities issued, issue costs, and so on, is normally better evidence of fair value than are appraisal values of the net assets of an acquired company. Thus, an adjusted market price of the shares issued is commonly used. Where the issued stock is of a new or closely held company, however, the fair value of the assets received must generally be used. Any security issuance costs, whether bonds or stocks, incurred to consummate the merger are deducted from the value assigned to the debt or equity.

LO6 Valuation of acquired assets and liabilities assumed.

Identifiable assets acquired (including intangibles other than goodwill) and liabilities assumed should be recorded at their fair values at the date of acquisition. Any excess of total cost over the sum of amounts assigned to identifiable assets and liabilities is recorded as goodwill. Goodwill should not be amortized but should be adjusted downward only when it is "impaired" as described in the preceding section.

In the past, managers seeking to reduce the amount of goodwill recorded as a result of the acquisition sometimes found creative ways to avoid or reduce goodwill prior to the issuance by increasing the amounts allocated to other accounts. One tactic involved identifying *in-process research and development (R&D)* in the acquired company. FASB standards require that R&D costs be expensed as incurred, not capitalized. In an interpretation of the standard on R&D, FASB stated that some forms of R&D, including a specific research project in progress, which transferred in an acquisition, should also be expensed. Furthermore, the amount to be expensed was to be determined not by the original cost of the actual R&D but by the amount paid by the acquiring company. **However, under current GAAP, in-process R&D is measured and recorded at fair value as an asset on the acquisition date.** This requirement does not extend to R&D in contexts other than business combinations. In any event, the importance of maintaining supporting documentation for any amounts assigned to R&D is clear.

St. Jude Medical, Inc. announced that it will acquire Irvine Biomedical, Inc. (IBI), an Irvine, California-based company that develops electrophysiology (EP) catheter products used by physician specialists to diagnose and treat cardiac rhythm disorders. St. Jude foresees recording an in-process R&D charge of $8 to $10 million at closing in connection with this acquisition. Apart from this in-process R&D charge, the transaction will not impact St. Jude's existing EPS guidance for 2004.[12]

[11] *MarketWatch.com*, "Bank of New York, J.P. Morgan Swap Assets," by Kathie O'Donnell, 4/8/06.

[12] *Business Wire*, "St. Jude Medical Announces Agreement to Acquire Irvine Biomedical, Inc.," 8/10/04.

When the net amount of the fair values of identifiable assets less liabilities ***exceeds the total cost*** of the acquired company, the acquisition is sometimes referred to as a **bargain**. When a bargain acquisition occurs, either some of the acquired assets must be adjusted downward or a gain must be recognized to balance the accounts. Because of its reluctance to recognize income in a purchase or acquisition (where the usual facets of revenue recognition are absent), the FASB had, in the past, required that most long-lived assets be written down on a pro rata basis in such a situation before recognizing any gain. The Exposure Draft differs markedly. It advises that the fair values be considered carefully, and adjustments made as needed. It does not, however, require that any asset be marked down *below* its fair value. Once that determination is established, then **the excess of acquisition-date fair value of net assets over the consideration paid is recognized in income**.

Acquisition Example Assume that on January 1, 2012, P Company, in a merger, ***acquired the assets*** and assumed the liabilities of S Company. P Company gave one of its $15 par value common shares to the former stockholders of S Company for every two shares of the $5 par value common stock they held. Throughout this text, the company names P and S are frequently used to distinguish a parent company from a subsidiary. In an asset acquisition, these terms are inappropriate because the books of the acquired firm are dissolved at the time of acquisition. Nonetheless, the distinction is useful to avoid confusion between the acquirer and the acquired.

P Company common stock, which was selling at a range of $50 to $52 per share during an extended period prior to the combination, is considered to have a fair value per share of $48 after an appropriate reduction is made in its market value for additional shares issued and for issue costs. The total value of the stock issued is $1,440,000 ($48 × 30,000 shares). Balance sheets for P and S companies (along with relevant fair value data) on January 1, 2012, are presented in Illustration 2-2. Because the book value of the bonds is $400,000, bond discount in the amount of $50,000 ($400,000 − $350,000) must be recorded to reduce the bonds payable to their present value.

To record the exchange of stock for the net assets of S Company, P Company will make the following entry:

Cash and Receivables	170,000	
Inventories	140,000	
Land	400,000	
Buildings & Equipment (net)	1,000,000	
Discount on Bonds Payable	50,000	
Goodwill (1,440,000 − 1,210,000**)	230,000	
Current Liabilities		150,000
Bonds Payable		400,000
Common Stock* (30,000 × $15)		450,000
Other Contributed Capital* (30,000 × [$48 − $15])		990,000

* The sum of common stock and other contributed capital is $1,440,000.
** Fair value of net assets = $1,710,000 − $500,000 = $1,210,000.

After the merger, S Company ceases to exist as a separate legal entity. Note that under the acquisition method the cost of the net assets is measured by the fair value

ILLUSTRATION 2-2
Balance Sheets of P and S Companies January 1, 2012

	P Company	*S Company*	
	Book Value	*Book Value*	*Fair Value*
Cash and receivables	$ 250,000	$ 180,000	$ 170,000
Inventories	260,000	100,000	140,000
Land	600,000	120,000	400,000
Buildings & equipment	800,000	900,000	1,000,000
Accumulated depreciation—buildings & equipment	(300,000)	(300,000)	
Total assets	$1,610,000	$1,000,000	$1,710,000
Current liabilities	$ 110,000	$ 110,000	$ 150,000
Bonds payable, 9%, due 1/1/2018, interest payable semiannually on 6/30 and 12/31*	—0—	400,000	350,000
Total liabilities	$ 110,000	$ 510,000	$ 500,000
Stockholders' Equity			
Common stock, $15 par value, 50,000 shares	750,000		
Common stock, $5 par value, 60,000 shares		300,000	
Other contributed capital	400,000	50,000	
Retained earnings	350,000	140,000	
Total Stockholders' equity	1,500,000	490,000	
Total liabilities and stockholders' equity	$1,610,000	$1,000,000	
Net assets at book value (Assets minus liabilities)	$1,500,000	$ 490,000	
Net assets at fair value			$1,210,000

* Bonds payable are valued at their present value by discounting the future payments at the current market rate.

(30,000 shares × $48 = $1,440,000) of the shares given in exchange. Common stock is credited for the par value of the shares issued, with the remainder credited to other contributed capital. Individual assets acquired and liabilities assumed are recorded at their fair values. Plant assets are recorded at their fair values in their current depreciated state (without an initial balance in accumulated depreciation), the customary procedure for recording the purchase of new or used assets. Bonds payable are recorded at their fair value by recognizing a premium or a discount on the bonds. After all assets and liabilities have been recorded at their fair values, an excess of cost over fair value of $230,000 remains and is recorded as goodwill.

A balance sheet prepared after the acquisition of S Company is presented in Illustration 2-3.

If an acquisition takes place within a fiscal period, GAAP requires the inclusion of the acquired company's revenues and expenses in the purchaser's income statement only from the date of acquisition forward. Income earned by the acquired company prior to the date of acquisition is considered to be included in the net assets acquired.

Income Tax Consequences in Business Combinations

The fair values of specific assets acquired and liabilities assumed in a business combination may differ from the income tax bases of those items. A deferred tax asset or liability should be recognized for differences between the assigned values

ILLUSTRATION 2-3

P Company Balance Sheet after Acquisition, January 1, 2012

Cash and receivables		$ 420,000
Inventories		400,000
Land		1,000,000
Buildings & equipment	1,800,000	
Accumulated depreciation—buildings & equipment	(300,000)	1,500,000
Goodwill		230,000
Total assets		$3,550,000
Current liabilities		$ 260,000
Bonds payable	$400,000	
Less: Bond discount	50,000	350,000
Total liabilities		610,000
Common stock, $15 par value, 80,000 shares outstanding	1,200,000	
Other contributed capital	1,390,000	
Retained earnings	350,000	
Stockholders' equity		2,940,000
Total liabilities and equity		$3,550,000

and tax bases of the assets and liabilities recognized in a business combination. The treatment of income tax consequences is addressed in Appendix A.

Bargain Acquisition Illustration (Purchase Price Below Fair Value of Identifiable Net Assets)

When the price paid to acquire another firm is lower than the fair value of identifiable net assets (assets minus liabilities), the acquisition is referred to as a ***bargain***. Although less common than acquisitions involving goodwill, bargain acquisitions do occur and require the application of specific rules to conform to generally accepted accounting principles. However, FASB simplified this issue.

Chicago-based Abbott Laboratories completed its $4.1 billion cash acquisition of Guidant Corp.'s vascular-device business. Abbott originally agreed to the purchase during the bidding war between Johnson & Johnson and Boston Scientific over cardiac-device maker Guidant. Abbott's vascular operations generated just $253 million in revenues in 2005 while Guidant's had more than $1 billion in 2005. Abbott said it expects the combined vascular group to have revenue of $3 billion in 2006. Experts consider Abbott to have obtained a solid bargain in its purchase.[13]

[13] *Chicago Tribune*, "Abbott Completes Vascular Purchase," James P. Miller, 4/22/06.

RELATED CONCEPTS

Because a gain incurred on purchase of assets, or a related firm, does not meet the conceptual view of appropriate *revenue recognition* (no earnings process has occurred), FASB continues to strive to find the best approach for bargain acquisitions.

- Any previously recorded goodwill on the seller's books is eliminated (and no new goodwill recorded).
- A **gain** is reflected in current earnings of the acquiree to the extent that the fair value of net assets exceeds the consideration paid.[14]

Example of a Bargain Purchase Assume that Payless Company pays $17,000 cash for all the net assets of Shoddy Company when Shoddy Company's balance sheet shows the following book values and fair values:

	Book Value	*Fair Value*
Current Assets	$ 5,000	$ 5,000
Buildings (net)	10,000	15,000
Land	3,000	5,000
Total Assets	$18,000	$25,000
Liabilities	$ 2,000	$ 2,000
Common Stock	9,000	
Retained Earnings	7,000	
Total Liabilities and Equity	$18,000	
Net Assets at Book Value	$16,000	
Net Assets at Fair Value		$23,000

Cost of the acquisition ($17,000) minus the fair value of net assets acquired ($23,000) produces a bargain, or an excess of fair value of net assets acquired over cost of $6,000.

The entry by Payless Company to record the acquisition is then:

Current Assets	5,000	
Buildings	15,000	
Land	5,000	
Liabilities		2,000
Cash		17,000
Gain on acquisition of Shoddy (ordinary)		6,000

CONTINGENT CONSIDERATION IN AN ACQUISITION

LO7 Contingent consideration and valuation of assets.

Purchase agreements sometimes provide that the purchasing company will give additional consideration to the seller if certain specified future events or transactions occur. The contingency may require the payment of cash (or other assets) or the issuance of additional securities. Current GAAP requires that all contractual contingencies, as well as non-contractual liabilities for which it is **more likely than not** that an asset or liability exists, be measured and recognized at fair value on the

[14] Under previous GAAP, the excess of fair value over cost was allocated to reduce long-lived assets (with certain specified exceptions) in proportion to their fair values in determining their assigned values. If the long-lived assets were reduced to zero, and still an excess remained, an extraordinary gain was recognized under *SFAS No. 141*. Prior to *SFAS No. 141*, negative goodwill was recorded as a deferred credit and amortized. Current GAAP does not permit the recording of negative goodwill in this manner nor is the recognized gain to be treated as extraordinary.

acquisition date.* This includes contingencies based on earnings, guarantees of future security prices, and contingent payouts based on the outcome of a lawsuit. For example, if the acquirer agrees to transfer additional equity interests, cash or other assets to the former owners of the acquiree at some future date if *specified targets are met,* the acquirer should measure and recognize the fair value of the *contingent consideration* as of the acquisition date. That consideration would be classified as either debt or equity on the basis of other generally accepted accounted principles.

As discussed in Chapter 1, the expected contribution by the acquired company to the future earnings of the acquiring company is an important element in determining the price to be paid for the acquired company. Because future earnings are unknown, the purchase agreement may contain a provision that the purchaser will give additional consideration to the former stockholders of the acquired company if the combined company's earnings equal or exceed a specified amount over some specified period. In essence, the parties to the business combination agree that the total price to be paid for the acquired company will not be known until the end of the contingency period. Nonetheless, the fair value must be estimated and recognized on the acquisition date. Subsequent adjustments usually result from events or changes in circumstances that take place after the acquisition date and, thus, should not be treated as adjustments to the consideration paid.

As an example, assume that P Company acquired all the net assets of S Company in exchange for P Company's common stock. P Company also agreed to pay an additional $150,000 to the former stockholders of S Company if the average postcombination earnings over the next two years equaled or exceeded $800,000. Assume that goodwill was recorded in the original acquisition transaction. To complete the recording of the acquisition, P Company will make the following entry:

Goodwill	150,000	
Liability for Contingent Consideration		150,000

Assuming that the target is met, P Company will make the following entry:

Liability for Contingent Consideration	150,000	
Cash		150,000

On the other hand, assume that the target is not met. In FASB ASC paragraph, the conditions that kept the target from being met occurred in a subsequent period, and P Company had the information to measure the liability at the acquisition date based on circumstances that existed at that time. Thus the adjustment will flow through the income statement in the subsequent period, as follows:

Liability for Contingent Consideration	150,000	
Income from Change in Estimate		150,000

* Otherwise, non-contractual liabilities are recorded under other applicable GAAP, such as *SFAS No. 5* [topic 450].

If the contingent consideration took the form of stock instead of cash, it would be classified as Paid-in-Capital from Contingent Consideration Issuable. Contingent consideration classified as equity shall not be remeasured. For example, suppose that P Company acquired all the net assets of S Company in exchange for P Company's common stock. P Company also agreed to issue additional shares of common stock to the former stockholders of S Company if the average postcombination earnings over the next two years equalled or exceeded $800,000. Assume that the contingency is expected to be met, and goodwill was recorded in the original acquisition transaction. Based on the information available at the acquisition date, the additional 10,000 shares (par value of $1 per share) expected to be issued are valued at $150,000. To complete the recording of the acquisition, P Company will make the following entry:

Goodwill	150,000	
Paid-in-Capital for Contingent Consideration		150,000

Assuming that the target is met, but the stock price has increased from $15 per share to $18 per share at the time of issuance, P Company will not adjust the original amount recorded as equity. Thus, P Company will make the following entry:

Paid-in-Capital for Contingent Consideration	150,000	
Common Stock ($1 par)		10,000
Paid-in-Capital in Excess of Par		140,000

Adjustments During the Measurement Period

The **measurement period** is the period after the initial acquisition date during which the acquirer may adjust the provisional amounts recognized at the acquisition date. This period allows a reasonable time to obtain the information necessary to identify and measure the fair value of the acquiree's assets and liabilities, as well as the fair value of the consideration transferred. If some of the measurements can only be determined provisionally by the end of the period in which the business combination occurs, the acquirer should report those provisional determinations in the financial statements.

During the measurement period, the acquirer can adjust the provisional amounts initially recorded (usually an increase or decrease in goodwill, unless the new information relates to a specific asset or liability) to reflect new information that surfaces during this period that would have altered the measurement if it had been known on the acquisition date. **The measurement period ends as soon as the acquirer has the needed information about facts and circumstances (or learns that the information is unobtainable), not to exceed one year from the acquisition date.**

Contingency Based on Outcome of a Lawsuit

To illustrate, assume that P Company acquires S Company on December 31, 2012, for cash plus contingent consideration depending on the assessment of a lawsuit against S Company assumed by P Company. The initial provisional assessment

includes an estimated liability for the lawsuit of $250,000, an estimated contingent liability to the shareholders of $25,000, and goodwill of $330,000. The acquisition contract specifies the following conditions: So long as the lawsuit is settled for less than $500,000, S Company shareholders will receive some additional consideration. If the lawsuit results in a settlement of $500,000 or more, then S Company shareholders will receive no additional consideration. If the settlement is resolved with a smaller (larger) outlay than anticipated ($250,000), the shareholders of S Company will receive additional (reduced) consideration accordingly, thus adjusting the contingent liability above or below $25,000. Suppose that during the measurement period, new information reveals the estimated liability for the lawsuit to be $275,000, and the estimated contingent liability to the shareholders to be $22,500. **Because the new information was (a) obtained during the measurement period, and (b) related to circumstances that existed at the acquisition date, the following journal entry would be made to complete the initial recording of the business combination:**

Goodwill	22,500	
Liability for Contingent Consideration	2,500	
Estimated Liability for Lawsuit		25,000

In some cases, consideration contingently issuable may depend on both future earnings and future security prices. In such cases, an additional cost of the acquired company should be recorded for all additional consideration contingent on future events, based on the best available information and estimates at the acquisition date (as adjusted by the end of the measurement period for facts that existed at the acquisition date).

In a deal that would represent a significant step in connecting railway systems in the United States and Mexico, Kansas City Southern agreed to acquire full control of Mexico's most important railroad, Grupo Transportacion Ferroviaria Mexicana SA, known as Grupo TFM. The cash-and-stock deal is currently valued at $555.1 million and could rise to $665.1 million if contingent payments are paid. KC Southern will pay the $110 million in contingency payments if Grupo TFM is able to repurchase the Mexican government's 20% financial stake in the company in exchange for Grupo TFM dropping a tax lawsuit against the Mexican government.[15]

Contingent payments based on earnings appear in only a small fraction of deals, accounting for an even smaller percentage of total dollar value overall. Although they may be helpful in getting past negotiating obstacles and possibly in reducing up-front payouts for buyers, they suffer from drawbacks in implementation. In particular, they are very difficult to administer and may trigger post-deal conflicts between buyers and sellers. Their primary niche is in the acquisition of private

[15] *WSJ*, "Kansas City Southern to Buy Mexican Railroad," by Daniel Machalaba and Joel Millman, 12/16/04, p. A9.

ILLUSTRATION 2-4

Deals with Contingent Payments 2000 to 2006 ($ Billions)

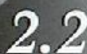
Year	*No. of Deals*	*Value*	*Earn-out Value*
2000	140	32.2	5.9
2001	120	20.7	6.1
2002	118	9.8	2.5
2003	92	20.2	5.0
2004	123	13.9	4.5
2005	127	19.5	4.6
2006	175	29.2	5.3

Source: *Mergers & Acquisitions,* February 2007.

companies where management retention is a key issue. Other places where they are used include cross-border deals and deals where corporate sellers wish to maintain a share in future performance. Illustration 2-4 summarizes recent trends related to the use of contingent payments.

TEST YOUR KNOWLEDGE

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



Multiple Choice

1. In the year of a material business combination, pro forma disclosures must include all of the following except:
   a. Revenue
   b. Net income
   c. Tax expenses
   d. Nonrecurring items
2. Which of the following statements best describes the current authoritative position with regard to the accounting for contingent consideration?
   a. If contingent consideration depends on both future earnings and future security prices, an additional cost of the acquired company should be recorded only for the portion of consideration dependent on future earnings.
   b. The measurement period for adjusting provisional amounts always ends at the year-end of the period in which the acquisition occurred.
   c. A contingency based on security prices has no effect on the determination of cost to the acquiring company.
   d. The purpose of the measurement period is to provide a reasonable time to obtain the information necessary to identify and measure the fair value of the acquiree's assets and liabilities, as well as the fair value of the consideration transferred.
3. Which of the following statements concerning bargain purchases (purchase price below fair value of identifiable assets) is *correct*?
   a. Any previously recorded goodwill on the seller's books is eliminated and no new goodwill is recorded.
   b. Long-lived assets, including in-process R&D and excluding marketable securities, are recorded at fair market value minus an adjustment for the bargain, under current GAAP.

c. An extraordinary gain is recorded in the event that all long-lived assets other than marketable securities are reduced to the original purchase price, under current GAAP.

d. Current assets, long-term investments in marketable securities (other than those accounted for by the equity method), assets to be disposed by sale, deferred tax assets, prepaid assets relating to pension or other post-retirement benefit plans, and assumed liabilities are the only accounts that are always recorded at fair market value, under current GAAP.

LEVERAGED BUYOUTS

LO8 Leveraged buyouts.

A *leveraged buyout (LBO)* occurs when a group of employees (generally a management group) and third-party investors create a new company to acquire all the outstanding common shares of their employer company. The management group contributes whatever stock they hold to the new corporation and borrows sufficient funds to acquire the remainder of the common stock. The old corporation is then merged into the new corporation. The LBO term results because most of the capital of the new corporation comes from borrowed funds. The LBO market rose dramatically from 1997 to 2007, as evidenced in Illustration 2-5, before dropping off in 2008 and 2009. In 2010, the number of leveraged buyouts increased by 53% over the number in 2009.

IN THE NEWS

Kohlberg Kravis Roberts & Co. (KKR) agreed to purchase Flextronics Software Systems for $900 million, making the deal India's biggest leveraged buyout ever. Under the agreement, Singapore-based Flextronics International Ltd., the world's largest producer of electronics for other companies, will sell 85% of the unit to KKR. The investment in Flextronics Software surpasses General Electric Co.'s 2004 sale of its Indian call-center group to buyout firms General Atlantic Partners LLC and Oak Hill Capital Partners LP for $500 million.[16]

ILLUSTRATION 2-5

The Leveraged Buyout Market (LBO) 2000–2009

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

Source: *Mergers & Acquisitions*, February 2009, 2010, 2011.

[16] *Bloomberg.com*, "KKR Acquires Flextronics Software in India's Biggest Buyout," by Vivek Shankar, 4/17/06.

The basic accounting question relates to the net asset values (fair or book) to be used by the new corporation. Accounting procedures generally followed the rules advocated by the Emerging Issues Task Force in *Consensus Position No. 88–16*, which did not view LBOs as business combinations. *FASB Statement No. 141R* did not comprehensively address this issue but did indicate that this position was no longer applicable. The essence of the change suggests that the economic entity concept should be applied here as well; thus leveraged buyout (LBO) transactions are now to be viewed as business combinations.

IFRS VERSUS U.S. GAAP

As mentioned in Chapter 1, the project on business combinations was the first of several joint projects undertaken by the FASB and the IASB in their move to converge standards globally. Nonetheless, complete convergence has not yet occurred. Most significantly the international standard currently allows the user a choice between writing all assets, including goodwill, up fully (100% including the noncontrolling share), as required now under U.S. GAAP, or continuing to write goodwill up only to the extent of the parent's percentage of ownership. This difference will be illustrated more fully in subsequent chapters in the context of stock (rather than asset) acquisitions. Other differences and similarities are summarized in Illustration 2-6.

ILLUSTRATION 2-6

Comparison of Business Combinations and Consolidations under U.S. GAAP and IFRS*

U.S. GAAP	*IFRS*
1. Fair value of **contingent consideration** recorded at acquisition date, with subsequent adjustments recognized through earnings if contingent liability (no adjustment for equity).	1. IFRS 3R uses the same approach.
2. **Contingent assets and liabilities** assumed (such as warranties) are measured at fair value on the acquisition date if they can be reasonable estimated. If not, they are treated according to *SFAS No. 5.*	2. Under IFRS 3R a contingent liability is recognized at the acquisition date if its fair value can be reliably measured.
3. **Noncontrolling interest** is recorded at fair value and is presented in equity.	3. Noncontrolling interest can be recorded either at fair value or at the proportionate share of the net assets acquired. Also presented in equity.
4. **Special purpose entities** (SPEs) are consolidated if the most significant activities of the SPE are controlled. Qualified SPEs (QSPEs) are no longer exempted from consolidation rules.	4. Special purpose entities (SPEs) are consolidated if controlled. QSPEs are not addressed.
5. **Direct acquisition costs** (excluding the costs of issuing debt or equity securities) are expensed.	5. IFRS 3R uses the same approach.
6. **Goodwill** is not amortized, but is tested for impairment using a two-step process.	6. Goodwill is not amortized, but is tested for impairment using a one-step process.

(continued)

ILLUSTRATION 2-6 (*continued*)

7. **Negative goodwill** in an acquisition is recorded as an ordinary gain in income (not extraordinary).	7. IAS 36 uses the same approach.
8. **Fair value** is based on exit prices, i.e. the price that would be received to sell an asset or paid to transfer a liability in an orderly transaction between market participants at the measurement date.	8. Fair value is the amount for which an asset could be exchanged or a liability settled between knowledgeable, willing parties in an arm's length transaction.
9. **Purchased in-process R&D** is capitalized with subsequent expenditures expensed. The capitalized portion is then amortized.	9. Purchased in-process R&D is capitalized with the potential for subsequent expenditures to be capitalized. The capitalized portion is then amortized.
10. Parent and subsidiary **accounting policies** *do not need* to conform.	10. Parent and subsidiary accounting policies *do need* to conform.
11. **Restructuring plans** are accounted for separately from the business combination and generally expensed (unless conditions in *SFAS No. 146* [ASC 420] are met).	11. Similar accounting under IFRS 3 and amended IAS 27.
12. **Measurement period** ends at the earlier of a) one year from the acquisition date, or b) the date when the acquirer receives needed information to consummate the acquisition.	12. IFRS 3 is similar to U.S. GAAP.
13. For **step acquisitions**, all previous ownership interests are adjusted to fair value, with any gain or loss recorded in earnings.	13. IFRS 3 is similar to U.S. GAAP.
14 . **Reporting dates** for the parent and subsidiary can be different up to three months. Significant events in that time must be *disclosed*.	14. Permits a three-month difference if impractical to prepare the subsidiary's statements on the same date; however, *adjustments are required* for significant events in that period.
15. Potential voting rights are generally not considered in determining **control**.	15. Potential voting rights are considered if currently exercisable.

IFRS

* For complete coverage of the differences between IFRS and U.S. GAAP, see *IFRS 2010, Interpretation and Application of International Financial Reporting Standards*, by Epstein and Jermakowicz, 2010 (John Wiley & Sons, Inc.).

SUMMARY

1. *Describe the changes in the accounting for business combinations approved by the FASB in 2007, and the reasons for those changes.* Under *SFAS No. 141R* [ASC 805], the fair values of all assets and liabilities on the acquisition date, defined as the date the acquirer obtains control of the acquiree, are reflected in the financial statements, even if control is obtained with less than 100% ownership and even if control is achieved in stages rather than all at once. *SFAS No. 141R* [ASC 805] also broadens the scope from that of *SFAS No. 141* to apply to business combinations involving only mutual entities, those achieved by contract alone, and the initial consolidation of variable interest entities (VIEs). *SFAS No. 160* [ASC 810-10-45-15 and 16] establishes standards for the reporting of the noncontrolling interest when the acquirer obtains control without purchasing 100% of the acquiree.

2. *Describe the two major changes in the accounting for business combinations approved by the FASB in 2001, as well as the reasons for those changes.* Of the two methods of accounting historically used in the United States—***purchase*** (now called acquisition)and ***pooling of interests***—pooling is now prohibited. In addition, the goodwill often recorded under the acquisition method is no longer amortized but instead is reviewed periodically for impairment. The standard setters believe that virtually all business combinations are acquisitions and thus should be accounted for in the same way that other asset acquisitions are accounted for, based on the fair values exchanged. Furthermore, users need better information about intangible assets, such as the goodwill that was not recorded in a pooling. The decision to discontinue the amortization of goodwill appears to be largely the result of pressure applied to the FASB and a fear that economic activity and competitive position internationally might otherwise be injured.

3. *Discuss the goodwill impairment test, including its frequency, the steps laid out in the standard, and some of the implementation problems.* Goodwill impairment for each reporting unit should be tested in a two-step process at least once a year. In the first step, the fair value of a reporting unit is compared to its carrying amount (goodwill included) at the date of the periodic review. If the fair value at the review date is less than the carrying amount, then the second step is necessary. In the second step, the carrying value of the goodwill is compared to its implied fair value (and a loss recognized when the carrying value is the higher of the two). To arrive at an implied fair value for the goodwill, the FASB specifies that an entity should allocate the fair value of the reporting unit at the review date to all of its assets and liabilities as if the unit had been acquired in a combination with the fair value of the unit as its purchase price. The excess of that fair value (purchase price) over the fair value of identifiable net assets is the implied fair value of the goodwill. Determining the fair value of the unit may prove difficult in cases where there are no quoted market prices. See Figure 2-1 for an illustration of the goodwill impairment rules.

4. *Explain how acquisition expenses are reported.* Acquisition-related costs are excluded from the measurement of the consideration paid, because such costs are not part of the fair value of the acquiree and are not assets. This is a change from past GAAP where the purchase method required only indirect costs to be expensed, while direct costs were capitalized as part of the purchase price. Current GAAP requires that both direct and indirect costs be expensed, and that the cost of issuing securities is also excluded from the consideration and accounted for separately from the business combination accounting.

5. *Describe the use of pro forma statements in business combinations.* Pro forma statements, sometimes called "as if" statements, are prepared to show the effect of planned or contemplated transactions by estimating how they might have affected the historical financial statements if they had been consummated during the period covered by those statements. Pro forma statements serve two functions in relation to business combinations: (1) to provide information in the ***planning*** stages of the combination and (2) to ***disclose*** relevant information subsequent to the combination.

6. *Describe the valuation of assets, including goodwill, and liabilities acquired in a business combination accounted for by the acquisition method.* Assets and liabilities acquired are recorded at their fair values. Any excess of cost over the fair value of net assets acquired is recorded as goodwill.

7. *Explain how contingent consideration affects the valuation of assets acquired in a business combination accounted for by the acquisition method.* If certain specified future events or transactions occur, the purchaser must pay additional consideration. The purchaser records the additional consideration at its fair value as an adjustment to the original purchase transaction. This entry is made to complete the recording of the business combination on the date of acquisition, based on the best information available at that time. Adjustments to provisional amounts may be made throughout the measurement period only if they reveal additional information about conditions that existed at the acquisition date. After the measurement date, subsequent adjustments for any contingent consideration recorded as a liability are recognized in the income statement; contingent consideration recorded as equity is not remeasured.

8. *Describe a leveraged buyout.* A leveraged buyout (LBO) occurs when a group of employees (generally a management group) and third-party

investors create a new company to acquire all the outstanding common shares of their employer company. The LBO term results because most of the capital of the new corporation comes from borrowed funds.

9. *Describe the disclosure requirements according to current GAAP related to each business combination that takes place during a given year.* Required disclosures include: the name and a description of the acquiree; the acquisition date; the percentage of voting equity instruments acquired; the primary reasons for the business combination; the fair value of the acquiree and the basis for measuring that value on the acquisition date; the fair value of the consideration transferred; the amounts recognized at the acquisition date for each major class of assets acquired and liabilities assumed; and the maximum potential amount of future payments the acquirer could be required to make under the terms of the acquisition agreement.

10. *Describe at least one of the differences between U.S. GAAP and IFRS related to the accounting for business combinations.* When a noncontrolling interest exists, IFRS allows a choice between recognizing goodwill fully or only to the extent of the acquired percentage, while U.S. GAAP requires full (100%) recognition of implied goodwill, even when a non-controlling interests remains.

APPENDIX A

Deferred Taxes in Business Combinations

A common motivation for the selling firm in a business combination is to structure the deal so that any gain is tax-free at the time of the combination. To the extent that the seller accepts common stock rather than cash or debt in exchange for the assets, the sellers may not have to pay taxes until a later date when the shares accepted are sold. In this situation, the acquiring firm inherits the book values of the assets acquired for *tax* purposes. When the acquirer has inherited the book values of the assets for tax purposes but has recorded market values for reporting purposes, a deferred tax liability needs to be recognized.

For example, suppose that Taxaware Company has net assets totaling $700,000 (market value), including fixed assets with a market value of $200,000 and a book value of $140,000. The book values of all other assets approximate market values. Taxaware Company is acquired by Blinko in a combination that qualifies as a *nontaxable exchange* for Taxaware shareholders. Blinko issues common stock valued at $800,000 (par value $150,000). First, if we disregard tax effects, the entry to record the acquisition would be:

Assets	$700,000	
Goodwill	100,000	
Common Stock		$150,000
Additional Contributed Capital		650,000

Now consider tax effects, assuming a 30% tax rate. First, the excess of market value over book value of the fixed assets creates a deferred tax liability because the excess depreciation is not tax deductible. Thus, the deferred tax liability associated with the fixed assets equals 30% × $60,000 (the difference between market and

book values), or $18,000. The inclusion of deferred taxes would increase goodwill by $18,000 to a total of $118,000. The entry to include goodwill is as follows:

Assets	700,000	
Goodwill	118,000	
Deferred Tax Liability (.3 × [200,000 − 140,000])		18,000
Common Stock		150,000
Additional Contributed Capital		650,000

The reader may be aware that in recent years in the United States, *the amortization of goodwill is often deductible on the tax return of the acquirer over a period of 15 years.* This, however, is **not the case in a nontaxable exchange, where the goodwill is not subject to amortization on either the tax return or the books under current GAAP.** Thus, in a nontaxable exchange, there is no obvious temporary difference related to the goodwill. In *FASB Statement No. 141R* [ASC 805–740] the FASB addressed the issue of deferred taxes in business combinations, stating its decision not to require deferred taxes be measured at fair value. The statement amends *FASB Statement No. 109*, and states that a deferred tax liability or asset should be recognized for differences between the recognized values of assets acquired and liabilities assumed in a business combination (except the portion of goodwill for which amortization is not deductible for tax purposes). Thus, we do not record a deferred tax liability on goodwill in this illustration.

Note, however, that in a *taxable exchange*, the excess amount of tax-deductible goodwill over the goodwill recorded in the books *does* meet the definition of a temporary difference. Further, *FASB Statement No. 141R* [ASC 805–740] addresses this issue explicitly, stating that the tax benefit in such a case should be recognized at the date of the business combination.

In FASB ASC 805-740-45-20, FASB also addressed changes in the valuation allowance on deferred tax assets. FASB requires that such an allowance be recognized when it is deemed more likely than not that some or all of the deferred tax asset will not be realized. Also, a change in the valuation allowance resulting from changed circumstances due to a business combination should be accounted for separately from the business combination. In other words, the change in the valuation allowance would be shown as income or expense in the period of the combination. FASB stated that this position was in line with the goal of convergence toward international standards. See Figure 2-2 for a summary of the changes in deferred taxes.

"Together, these statements [ASC 805] and [ASC 740] can affect acquisitions past, present, and future—dramatically changing the way companies account for future business combinations and minority interests (now noncontrolling interests). In some cases, they can affect the tax accounting for transactions completed prior to the effective date." Examples of potential changes from the prior standard include: the handling of tax uncertainties and their effect on the valuation allowance; the recording of a deferred tax asset when goodwill for tax is greater than book goodwill; the effect of contingent consideration on the purchase price, deferred tax assets, and the tax provision; and transaction costs that are now expensed for book as well as tax purposes (thus no deferred taxes).[17]

[17] Deloitte Tax Services, "Mergers and Acquisitions: Why Tax Accounting Will Never Be the Same Again," 2008 Deloitte Development LLC.

FIGURE 2-2

Summary of Selected Income Tax Changes: Old vs. New Application

	Old	*New*
Changes in the valuation allowance resulting from the business combination.	Decreases in the acquirer's valuation allowance are included in the business combination accounting.	Changes would be reflected in the income statement or in some cases, equity.
Subsequent changes in the valuation allowance related to the target's recorded tax attributes or the tax positions acquired.	All changes would first reduce goodwill to zero, then reduce other noncurrent intangibles to zero and lastly reduce income tax expense.	Changes would be reflected in the income statement or, in some cases, equity (not for measurement period adjustments). Accounting depends on whether the new information relates to conditions that existed at the acquisition date.
Excess of the tax-deductible amount over accounting goodwill.	No deferred tax asset recognized in the business combination; when the tax deduction is realized on the tax return, reduce goodwill to zero, then reduce other noncurrent intangibles to zero and finally reduce income tax expense.	Recognize a deferred tax asset.

TEST YOUR KNOWLEDGE SOLUTIONS

2-1 1. c
2. c
3. a

2-2 1. c
2. d
3. a

QUESTIONS

(The letter A after a question, exercise, or problem means that the question, exercise, or problem relates to Chapter Appendix A.)

LO7 **1.** When contingent consideration in an acquisition is based on security prices, how should this contingency be reflected on the acquisition date? If the estimate changes during the measurement period, how is this handled? If the estimate changes after the end of the measurement period, how is this adjustment handled? Why?

LO5 **2.** What are pro forma financial statements? What is their purpose?

LO3 **3.** How would a company determine whether goodwill has been impaired?

LO3 **4.** AOL announced that because of an accounting change (*FASB Statements Nos. 141R* [ASC 805] *and 142* [ASC 350]), earnings would be increasing over the next 25 years by $5.9 billion a year. What change(s) required by FASB (in *SFAS Nos. 141R and 142*) resulted in an increase in AOL's income? Would you expect this increase in earnings to have a positive impact on AOL's stock price? Why or why not?

Business Ethics

There have been several recent cases of a CEO or CFO resigning or being ousted for misrepresenting academic credentials. For instance, during February 2006, the CEO of RadioShack resigned by "mutual agreement" for inflating his educational background. During

2002, Veritas Software Corporation's CFO resigned after claiming to have an MBA from Stanford University. On the other hand, Bausch & Lomb Inc.'s board refused the CEO's offer to resign following a questionable claim to have an MBA.

Suppose you have been retained by the board of a company where the CEO has 'overstated' credentials. This company has a code of ethics and conduct which states that the employee should always do "the right thing."

(a) What is the board of directors' responsibility in such matters?

(b) What arguments would you make to ask the CEO to resign? What damage might be caused if the decision is made to retain the current CEO?

ANALYZING FINANCIAL STATEMENTS

AFS2-1 EBay Acquires Skype

On October 14, 2005, eBay acquired all of the outstanding securities of Skype Technologies S.A. ("Skype"), for a total initial consideration of approximately $2.593 billion, plus potential performance-based payments of up to approximately $1.3 billion (based on the euro–dollar exchange rate at the time of the acquisition). Thus the potential purchase price could attain a value of $3.9 billion. The net tangible and intangible assets acquired were $262 million.

The initial consideration of approximately $2.6 billion was comprised of approximately $1.3 billion in cash and 32.8 million shares of eBay's common stock. For accounting purposes, the stock portion of the initial consideration was valued at approximately $1.3 billion based on the average closing price of eBay's common stock surrounding the acquisition announcement date of September 12, 2005. The acquisition was treated as a non-taxable purchase transaction, and the purchase price was allocated to the tangible and intangible assets acquired and liabilities assumed based on their respective fair values at the acquisition date.

Conditions of the earnout: The maximum amount potentially payable under the performance-based earnout is approximately 1.1 billion euro, or approximately $1.5 billion (based on a U.S. dollar–to–euro exchange rate of $1.32), and would be payable in cash or common stock. The earn–out payments are contingent upon Skype achieving certain net revenue, gross profit margin–based, and active user targets. Base earnout payments of up to an aggregate of approximately 877 million euro, or approximately $1.2 billion, weighted equally among the three targets, would be payable if the targets are achieved over any four-quarter period commencing on January 1, 2006 through June 30, 2009. Additional bonus earnout payments of up to an aggregate of approximately 292 million euro, or approximately $386 million, weighted equally among the three targets, would be payable if Skype exceeds the targets during calendar year 2008. Any contingent earnout payments made would be accounted for as additional purchase price and would increase goodwill. As of December 31, 2006, the targets had not been met and accordingly, no payments had been made.

From eBay's 2007 annual report: In conjunction with the acquisition of Skype in 2005, eBay agreed to certain performance-based earnout payments. During the year ended December 31, 2007, eBay entered into an earnout settlement agreement with each of the former shareholders of Skype who had elected the earnout alternative at the time of the acquisition, under which eBay was relieved of all obligations under the original earnout agreement in exchange for an aggregate cash payment of 375.1 million euro, or approximately $530.3 million. Goodwill was recorded because the earnout settlement amount was considered additional purchase price. In addition, eBay recorded a charge for impairment of goodwill for $1.39 billion from the Skype acquisition.

Required:

A. Compute the amount of goodwill acquired when eBay acquired Skype.

B. Whenever contingent payments are used in an acquisition, it is important to identify the amounts that are part of the business combination or whether the transaction is separate from the business combination. FASB ASC paragraphs 805-10-55-18 through 25 identify factors that help to determine whether a transaction is part of the exchange for the acquiree or not. What are some of these conditions?

c. Skype's earnings performance in the years following the acquisition never qualified for additional consideration. In 2007, eBay entered into a cash settlement with all former shareholders of Skype with earnout provisions. EBay paid $530.3 million to be relieved of all obligations under the earnout provisions. Why would they want to do this?

AFS2-2 **eBay Sells Skype**

On November 19, 2009, eBay sold all the capital shares of Skype to Springboard Group. eBay received cash proceeds of approximately $1.9 billion, a subordinated note issued by a subsidiary of the Buyer in the principal amount of $125.0 million and an equity stake of approximately 30 percent in the outstanding capital stock of the Buyer (valued at $620.0 million).

The sale resulted in the removal of all Skype-related assets and liabilities, which offset the proceeds noted above, resulting in a net gain of $1.4 billion recorded in interest and other income. In conjunction with the sale of Skype, eBay reached a legal settlement of a lawsuit between Skype, Joltid, and entities controlled by Joltid's founders, resulting in a $343.2 million charge to general and administrative expense.

In addition, eBay recorded a charge for impairment of goodwill for $1.39 billion from the Skype acquisition.

From eBay's 2009 annual report:

eBay Inc.
Consolidated Statement of Income

	Year Ended December 31,		
	2007	2008	2009
	(In thousands, except per-share amounts)		
Net revenues	$7.672.329	$8,541,261	$8,727,362
Cost of net revenues	1,762,972	2,228,069	2,479,762
Gross profit	5,909,357	6,313,192	6,247,600
Operating expenses:			
Sales and marketing	1,882,810	1,881,551	1,885,677
Product development	619,727	725,600	803,070
General and administrative	904,681	998,871	1,418,389
Provision for transaction and loan losses	293,917	347,453	382,825
Amortization of acquired intangible assets	204,104	234,916	262,686
Restructuring	—	49,1 19	38,187
Impairment of goodwill	1,390,938	—	—
Total operating expenses	5,296,177	4,237,510	4,790,834
Income from operations	613,180	2,075,682	1,456,766
Interest and other income, net	137,671	107,882	1,422,385
Income before income taxes	750,851	2,183,564	2,879,151
Provision for income taxes	(402,600)	(404,090)	(490,054)
Net income	$ 348,251	$1,779,474	$2,389,097

Skype's operating performance (2007 through 2009), dollars in thousands:

	2007	2008	2009
Revenues	364,564	550,841	620,403
Direct expenses	337,338	434,588	462,701
Income	44,484	116,253	157,702

Required:

Examine eBay's income statement from 2007 to 2009. Reconstruct eBay's income statement excluding the effects of Skype. Use the following categories in your analysis: Net revenue, Total operating expenses, Operating income, Interest and other income, and Income before taxes.

EXERCISES

EXERCISE 2-1 Asset Purchase LO6

Preston Company acquired the assets (except for cash) and assumed the liabilities of Saville Company. Immediately prior to the acquisition, Saville Company's balance sheet was as follows:

	Book Value	*Fair Value*
Cash	$ 120,000	$ 120,000
Receivables (net)	192,000	228,000
Inventory	360,000	396,000
Plant and equipment (net)	480,000	540,000
Land	420,000	660,000
Total assets	$1,572,000	$1,944,000
Liabilities	$ 540,000	$ 594,000
Common stock ($5 par value)	480,000	
Other contributed capital	132,000	
Retained earnings	420,000	
Total equities	$1,572,000	

Required:

A. Prepare the journal entries on the books of Preston Company to record the purchase of the assets and assumption of the liabilities of Saville Company if the amount paid was $1,560,000 in cash.

B. Repeat the requirement in (A) assuming that the amount paid was $990,000.

EXERCISE 2-2 Acquisition Method LO6

The balance sheets of Petrello Company and Sanchez Company as of January 1, 2011, are presented below. On that date, after an extended period of negotiation, the two companies agreed to merge. To effect the merger, Petrello Company is to exchange its unissued common stock for all the outstanding shares of Sanchez Company in the ratio of $\frac{1}{2}$ share of Petrello for each share of Sanchez. Market values of the shares were agreed on as Petrello, $48; Sanchez, $24. The fair values of Sanchez Company's assets and liabilities are equal to their book values with the exception of plant and equipment, which has an estimated fair value of $720,000.

	Petrello	*Sanchez*
Cash	$ 480,000	$ 200,000
Receivables	480,000	240,000
Inventories	2,000,000	240,000
Plant and equipment (net)	3,840,000	800,000
Total assets	$6,800,000	$1,480,000
Liabilities	$1,200,000	$ 320,000
Common stock, $16 par value	3,440,000	800,000
Other contributed capital	400,000	—0—
Retained earnings	1,760,000	360,000
Total equities	$6,800,000	$1,480,000

Required:

Prepare a balance sheet for Petrello Company immediately after the merger.

EXERCISE 2-3 **Asset Purchase, Cash and Stock** LO6

Pretzel Company acquired the assets (except for cash) and assumed the liabilities of Salt Company on January 2, 2012. As compensation, Pretzel Company gave 30,000 shares of its common stock, 15,000 shares of its 10% preferred stock, and cash of $50,000 to the stockholders of Salt Company. On the acquisition date, Pretzel Company stock had the following characteristics:

PRETZEL COMPANY

Stock	*Par Value*	*Fair Value*
Common	$ 10	$ 25
Preferred	100	100

Immediately prior to the acquisition, Salt Company's balance sheet reported the following book values and fair values:

SALT COMPANY
Balance Sheet
January 2, 2012

	Book value	*Fair value*
Cash	$ 165,000	$ 165,000
Accounts receivable (net of $11,000 allowance)	220,000	198,000
Inventory—LIFO cost	275,000	330,000
Land	396,000	550,000
Buildings and equipment (net)	1,144,000	1,144,000
Total assets	$2,200,000	$2,387,000
Current liabilities	$ 275,000	$ 275,000
Bonds Payable, 10%	450,000	495,000
Common stock, $5 par value	770,000	
Other contributed capital	396,000	
Retained earnings	309,000	
Total liabilities and stockholders' equity	$2,200,000	

Required:

Prepare the journal entry on the books of Pretzel Company to record the acquisition of the assets and assumption of the liabilities of Salt Company.

EXERCISE 2-4 **Asset Purchase, Cash** LO6

P Company acquired the assets and assumed the liabilities of S Company on January 1, 2010, for $510,000 when S Company's balance sheet was as follows:

S COMPANY
Balance Sheet
January 1, 2010

Cash	$ 96,000
Receivables	55,200
Inventory	110,400
Land	169,200
Plant and equipment (net)	466,800
Total	$897,600
Accounts payable	$ 44,400
Bonds payable, 10%, due 12/31/2015, Par	480,000
Common stock, $2 par value	120,000
Retained earnings	253,200
Total	$897,600

Fair values of S Company's assets and liabilities were equal to their book values except for the following:

1. Inventory has a fair value of $126,000.
2. Land has a fair value of $198,000.
3. The bonds pay interest semiannually on June 30 and December 31. The current yield rate on bonds of similar risk is 8%.

Required:

Prepare the journal entry on P Company's books to record the acquisition of the assets and assumption of the liabilities of S Company.

EXERCISE 2-5 **Asset Purchase, Contingent Consideration** LO7

Pritano Company acquired all the net assets of Succo Company on December 31, 2010, for $2,160,000 cash. The balance sheet of Succo Company immediately prior to the acquisition showed:

	Book value	*Fair value*
Current assets	$ 960,000	$ 960,000
Plant and equipment	1,080,000	1,440,000
Total	$2,040,000	$2,400,000
Liabilities	$ 180,000	$ 216,000
Common stock	480,000	
Other contributed capital	600,000	
Retained earnings	780,000	
Total	$2,040,000	

As part of the negotiations, Pritano agreed to pay the stockholders of Succo $360,000 cash if the postcombination earnings of Pritano averaged $2,160,000 or more per year over the next two years.

Required:

Prepare the journal entries on the books of Pritano to record the acquisition on December 31, 2010. It is expected that the earnings target is likely to be met.

EXERCISE 2-6 **Asset Purchase, Contingent Consideration** LO7

On January 1, 2010, Platz Company acquired all the net assets of Satz Company by issuing 75,000 shares of its $10 par value common stock to the stockholders of Satz Company. During negotiations Platz Company agreed to issue additional shares of common stock to the stockholders of Satz if the average postcombination earnings over the next three years equaled or exceeded $2,500,000. On January 1, 2010 the market value of Platz stock was $50 per share. Based on the information available at the acquisition date, the additional 10,000 shares are expected to be issued.

Required:

A. Prepare the journal entry on Platz Company's books on January 1, 2010. It is expected that the earnings target is likely to be met. Platz Company records goodwill on acquisition.
B. Prepare the journal entry on Platz Company's books on January 1, 2014, when the additional shares are issued. On this date the market value of Platz stock is valued at $60 per share.

EXERCISE 2-7 **Multiple Choice** LO6

Price Company issued 8,000 shares of its $20 par value common stock for the net assets of Sims Company in a business combination under which Sims Company will be merged into Price Company. On the date of the combination, Price Company common stock had a fair value of $30 per share. Balance sheets for Price Company and Sims Company immediately prior to the combination were:

	Price	*Sims*
Current assets	$ 438,000	$ 64,000
Plant and equipment (net)	575,000	136,000
Total	$1,013,000	$200,000
Liabilities	$ 300,000	$ 50,000
Common stock, $20 par value	550,000	80,000
Other contributed capital	72,500	20,000
Retained earnings	90,500	50,000
Total	$1,013,000	$200,000

Required:

Select the letter of the best answer.

1. If the business combination is treated as a purchase and Sims Company's net assets have a fair value of $228,800, Price Company's balance sheet immediately after the combination will include goodwill of

(a) $10,200.
(b) $12,800.
(c) $11,200.
(d) $18,800.

2. If the business combination is treated as a purchase and the fair value of Sims Company's current assets is $90,000, its plant and equipment is $242,000, and its liabilities are $56,000, Price Company's balance sheet immediately after the combination will include

(a) Negative goodwill of $36,000.
(b) Plant and equipment of $817,000.
(c) Gain of $36,000.
(d) Goodwill of $36,000.

EXERCISE 2-8 **Purchase** LO6

Effective December 31, 2010, Zintel Corporation proposes to issue additional shares of its common stock in exchange for all the assets and liabilities of Smith Corporation and Platz Corporation, after which Smith and Platz will distribute the Zintel stock to their stockholders in complete liquidation and dissolution. Balance sheets of each of the corporations immediately prior to merger on December 31, 2010, follow. The common stock exchange ratio was negotiated to be 1:1 for both Smith and Platz.

	Zintel	*Smith*	*Platz*
Current assets	$1,600,000	$ 350,000	$ 12,000
Long-term assets (net)	5,700,000	1,890,000	98,000
Total	$7,300,000	$2,240,000	$110,000
Current liabilities	$ 700,000	$ 110,000	$ 9,000
Long-term debt	1,100,000	430,000	61,000
Common stock, $5 par value	2,500,000	700,000	20,000
Retained earnings	3,000,000	1,000,000	20,000
Total	$7,300,000	$2,240,000	$110,000

Required:

Prepare journal entries on Zintel's books to record the combination. Assume the following:

The identifiable assets and liabilities of Smith and Platz are all reflected in the balance sheets (above), and their recorded amounts are equal to their current fair values except for long-term assets. The fair value of Smith's long-term assets exceed their book value by $20,000, and the fair value of Platz's long-term assets exceed their book values by $5,000. Zintel's common stock is traded actively and has a current market price of $15 per share. Prepare journal entries on Zintel's books to record the combination. *(AICPA adapted)*

EXERCISE 2-9 **Allocation of Purchase Price to Various Assets and Liabilities** LO6

Company S has no long-term marketable securities. Assume the following scenarios:

Case A

Assume that P Company paid $130,000 cash for 100% of the net assets of S Company.

S COMPANY

	Assets			
	Current Assets	*Long-lived Assets*	*Liabilities*	*Net Assets*
Book Value	$15,000	$85,000	$20,000	$80,000
Fair Value	20,000	130,000	30,000	120,000

Case B

Assume that P Company paid $110,000 cash for 100% of the net assets of S Company.

S COMPANY

	Assets			
	Current Assets	*Long-lived Assets*	*Liabilities*	*Net Assets*
Book Value	$15,000	$85,000	$20,000	$80,000
Fair Value	30,000	80,000	20,000	90,000

Case C

Assume that P Company paid $15,000 cash for 100% of the net assets of S Company.

S COMPANY

	Assets			
	Current Assets	*Long-lived Assets*	*Liabilities*	*Net Assets*
Book Value	$15,000	$85,000	$20,000	$80,000
Fair Value	20,000	40,000	40,000	20,000

Required:

Complete the following schedule by listing the amount that would be recorded on P's books.

	Assets				*Retained Earnings*
	Goodwill	*Current Assets*	*Long-lived Assets*	*Liabilities*	*(Gain in Income Statement)*
Case A					
Case B					
Case C					

EXERCISE 2-10 **Goodwill Impairment Test** LO3

On January 1, 2010, Porsche Company acquired the net assets of Saab Company for $450,000 cash. The fair value of Saab's identifiable net assets was $375,000 on this date. Porsche Company decided to measure goodwill impairment using the present value of future cash flows to estimate the fair value of the reporting unit (Saab). The information for these subsequent years is as follows:

Year	*Present Value of Future Cash Flows*	*Carrying Value of Saab's Identifiable Net Assets**	*Fair Value Saab's Identifiable Net Assets*
2011	$400,000	$330,000	$340,000
2012	$400,000	$320,000	345,000
2013	$350,000	$300,000	325,000

* Identifiable net assets do not include goodwill.

Required:

Part A: For each year determine the amount of goodwill impairment, if any.

Part B: Prepare the journal entries needed each year to record the goodwill impairment (if any) on Porsche's books from 2011 to 2013.

Part C: How should goodwill (and its impairment) be presented on the balance sheet and the income statement in each year?

Part D: If goodwill is impaired, what additional information needs to be disclosed?

EXERCISE 2-11 **Relation between Purchase Price, Goodwill, and Negative Goodwill** LO6

The following balance sheets were reported on January 1, 2011, for Peach Company and Stream Company:

	Peach	*Stream*
Cash	$ 100,000	$ 20,000
Inventory	300,000	100,000
Equipment (net)	880,000	380,000
Total	$1,280,000	$500,000
Total Liabilities	$ 300,000	$100,000
Common stock, $20 par value	400,000	200,000
Other contributed capital	250,000	70,000
Retained earnings	330,000	130,000
Total	$1,280,000	$500,000

Required:

Appraisals reveal that the inventory has a fair value of $120,000, and the equipment has a current value of $410,000. The book value and fair value of liabilities are the same. Assuming that Peach Company wishes to acquire Stream for cash in an asset acquisition, determine the following cutoff amounts:

A. The purchase price above which Peach would record goodwill.

B. The purchase price below which the equipment would be recorded at less than its fair market value.

C. The purchase price below which Peach would record a gain.

D. The purchase price below which Peach would obtain a "bargain."

E. The purchase price at which Peach would record $50,000 of goodwill.

EXERCISE 2-12A Acquisition Entry, Deferred Taxes

Patel Company issued 100,000 shares of $1 par value common stock (market value of $6/share) for the net assets of Seely Company on January 1, 2011, in a statutory merger. Seely Company had the following assets, liabilities, and owners' equity at that time:

	Book Value		
	Tax Basis	*Fair Value*	*Difference*
Cash	$ 20,000	$ 20,000	$—0—
Accounts receivable	112,000	112,000	—0—
Inventory (LIFO)	82,000	134,000	52,000
Land	30,000	55,000	25,000
Plant assets (net)	392,000	463,000	71,000
Total assets	$636,000	$784,000	
Allowance for uncollectible accounts	$ 10,000	$ 10,000	$—0—
Accounts payable	54,000	54,000	—0—
Bonds payable	200,000	180,000	20,000
Common stock, $1 par value	80,000		
Other contributed capital	132,000		
Retained earnings	160,000		
Total equities	$636,000		

Required:

Prepare the journal entry to record the assets acquired and liabilities assumed. Assume an income tax rate of 40%.

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

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

ASC2-2 **General Principles** In the 1990s, the pooling of interest method was a preferred method of accounting for consolidations by many managers because of the creation of instant earnings if the acquisition occurred late in the year. Can the firms that used pooling of interest in the 1990s continue to use the method for those earlier consolidations, or were they required to adopt the new standards for previous business combinations retroactively?

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

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

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

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

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

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

PROBLEMS

PROBLEM 2-1 **Consolidation** LO6

Condensed balance sheets for Phillips Company and Solina Company on January 1, 2010, are as follows:

	Phillips	*Solina*
Current assets	$180,000	$ 85,000
Plant and equipment (net)	450,000	140,000
Total assets	$630,000	$225,000
Total liabilities	$ 95,000	$ 35,000
Common stock, $10 par value	350,000	160,000
Other contributed capital	125,000	53,000
Retained earnings (deficit)	60,000	(23,000)
Total liabilities and equities	$630,000	$225,000

On January 1, 2010, the stockholders of Phillips and Solina agreed to a consolidation. Because FASB requires that one party be recognized as the acquirer and the other as the acquiree, it was agreed that Phillips was acquiring Solina. Phillips agreed to issue 20,000 shares of its $10 par stock to acquire all the net assets of Solina at a time when the fair value of Phillips' common stock was $15 per share.

On the date of consolidation, the fair values of Solina's current assets and liabilities were equal to their book values. The fair value of plant and equipment was, however, $150,000. Phillips will incur $20,000 of direct acquisition costs and $6,000 in stock issue costs.

Required:

Prepare the journal entries on the books of Phillips to record the acquisition of Solina Company's net assets.

PROBLEM 2-2 **Merger and Consolidation, Goodwill Impairment** LO3 LO6

Stockholders of Acme Company, Baltic Company, and Colt Company are considering alternative arrangements for a business combination. Balance sheets and the fair values of each company's assets on October 1, 2011, were as follows:

	Acme	*Baltic*	*Colt*
Assets	$3,900,000	$7,500,000	$ 950,000
Liabilities	$2,030,000	$2,200,000	$ 260,000
Common stock, $20 par value	2,000,000	1,800,000	540,000
Other contributed capital	—0—	600,000	190,000
Retained earnings (deficit)	(130,000)	2,900,000	(40,000)
Total equities	$3,900,000	$7,500,000	$ 950,000
Fair values of assets	$4,200,000	$9,000,000	$1,300,000

Acme Company shares have a fair value of $50. A fair (market) price is not available for shares of the other companies because they are closely held. Fair values of liabilities equal book values.

Required:

A. Prepare a balance sheet for the business combination. Assume the following: Acme Company acquires all the assets and assumes all the liabilities of Baltic and Colt Companies by

cash payment of $800,000 and $300,000 in long-term 8% notes payable. Pepper Company's receivables include $60,000 owed by Salt Company. Pepper Company is willing to pay more than the book value of Salt Company assets because plant assets are undervalued by $215,000 and Salt Company has historically earned above-normal profits.

Required:
Prepare a pro forma balance sheet showing the effects of these planned transactions.

PROBLEM 2-6 Purchase, Decision to Accept LO5

Spalding Company has offered to sell to Ping Company its assets at their book values plus $1,800,000 representing payment for goodwill. Operating data for 2010 for the two companies are as follows:

	Ping Company	*Spalding Company*
Sales	$3,510,100	$2,365,800
Cost of goods sold	1,752,360	1,423,800
Gross profit	1,757,740	942,000
Selling expenses	$ 632,500	$ 292,100
Other expenses	172,600	150,000
Total expenses	805,100	442,100
Net income	$ 952,640	$ 499,900

Ping Company's management estimates the following operating changes if Spalding Company is merged with Ping Company through a purchase:

A. After the merger, the sales volume of Ping Company will be 20% in excess of the present combined sales volume, and the sale price per unit will be decreased by 10%.

B. Fixed manufacturing expenses have been 35% of cost of goods sold for each company. After the merger the fixed manufacturing expenses of Ping Company will be increased by 70% of the current fixed manufacturing expenses of Spalding Company. The current variable manufacturing expenses of Ping Company, which is 70% of cost of goods sold, is expected to increase in proportion to the increase in sales volume.

C. Selling expenses of Ping Company are expected to be 85% of the present combined selling expenses of the two companies.

D. Other expenses of Ping Company are expected to increase by 85% as a result of the merger.

Any excess of the estimated net income of the merged company over the combined present net income of the two companies is to be capitalized at 20%. If this amount exceeds the price set by Spalding Company for goodwill, Ping Company will accept the offer.

Required:
Prepare a pro forma (or projected) income statement for Ping Company for 2011 assuming the merger takes place, and indicate whether Ping Company should accept the offer.

PROBLEM 2-7A Acquisition Entry and Deferred Taxes

On January 1, 2012, Pruitt Company issued 30,000 shares of its $2 par value common stock for the net assets of Shah Company in a statutory merger accounted for as a purchase. Pruitt's common stock had a fair value of $28 per share at that time. A schedule of the Shah Company assets acquired and liabilities assumed at book values (which are equal to their tax bases) and fair values follows:

Item	*Book Value/Tax Basis*	*Fair Value*	*Excess*
Receivables (net)	$125,000	$ 125,000	$ —0—
Inventory	167,000	195,000	28,000
Land	86,500	120,000	33,500
Plant assets (net)	467,000	567,000	100,000
Patents	95,000	200,000	105,000
Total	$940,500	$1,207,000	$266,500
Current liabilities	$ 89,500	$ 89,500	$—0—
Bonds payable	300,000	360,000	60,000
Common stock	120,000		
Other contributed capital	164,000		
Retained earnings	267,000		
Total	$940,500		

Additional Information:

1. Pruitt's income tax rate is 35%.
2. Shah's beginning inventory was all sold during 2012.
3. Useful lives for depreciation and amortization purposes are:

Plant assets	10 years
Patents	8 years
Bond premium	10 years

4. Pruitt uses the straight-line method for all depreciation and amortization purposes.

Required:

A. Prepare the entry on Pruitt Company's books to record the acquisition of the assets and assumption of the liabilities of Shah Company.

B. Assuming Pruitt Company had taxable income of $468,000 in 2012, prepare the income tax entry for 2012.