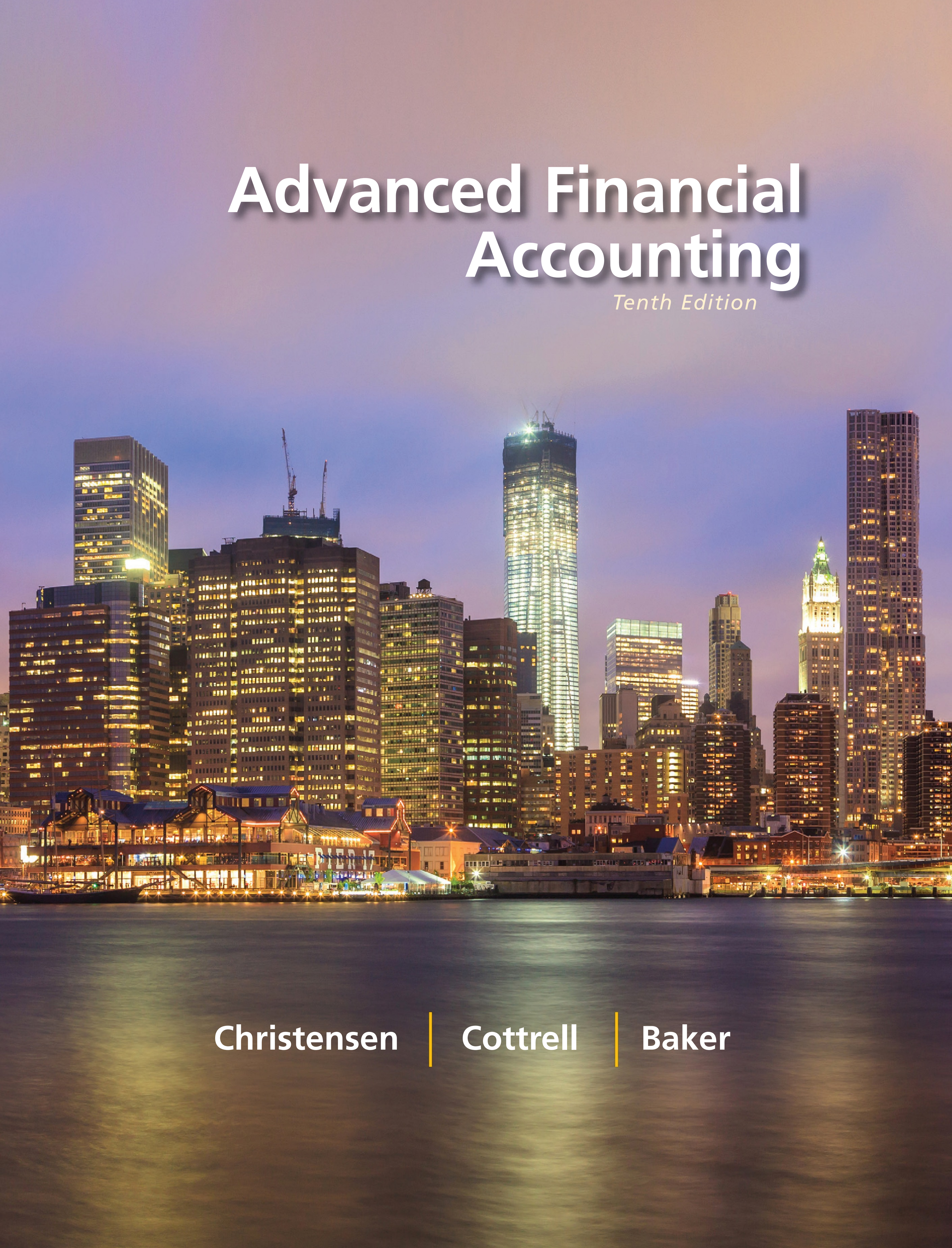
Advanced Financial Accounting

Tenth Edition



Christensen | Cottrell | Baker

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KRAFT'S ACQUISITION OF CADBURY

In recent years as well as during the past several decades, the business world has witnessed many corporate acquisitions and combinations, often involving some of the world's largest and best-known companies. Some of these combinations have captured public attention because of the personalities involved, the daring strategies employed, and the huge sums of money at stake. On February 2, 2010, Kraft Foods Inc. finalized a deal to acquire Cadbury PLC for $18.5 billion, forming the second-largest confectionery, food, and beverage company in the world. At the time of the acquisition, Cadbury's net assets were worth only around $4.6 billion. This highly visible transaction was really the next step in more than a century of regular acquisitions.

In 1896, inspired in part by his time in the Kellogg brothers' Battle Creek Sanitarium, C.W. Post founded Postum Cereal Company, Ltd. The following year he introduced Grape-Nuts brand cereal. Within five years, Postum employed 2,500 people and its Battle Creek facility was the largest of its kind in the world.

In 1903, James L. Kraft started selling cheese door to door from the back of a horse-drawn wagon. Although not immediately successful, he continued operations and was eventually joined by four of his brothers in 1909. By 1914, Kraft & Bros. Company (later Kraft Foods Inc.) had opened its first cheese manufacturing plant and in 1916 patented a new process for pasteurizing cheese, making the cheese resistant to spoilage and allowing it to be transported over long distances.

These two start-up companies (Kraft and Postum) continued to grow independently. Postum went public in 1922, followed by Kraft in 1924. In 1929, Postum changed its name to General Foods Corporation and in 1930, Kraft was acquired by National Dairy Products. In 1937, Kraft launched its well-known macaroni and cheese dinners. By 1953, business was booming for General Foods, and it acquired Perkins Products, maker of Kool-Aid. In 1981, General Foods made another acquisition, this time acquiring Oscar Mayer & Co.

Philip Morris acquired General Foods in 1985 and Kraft in 1988. A year later, General Foods and Kraft were combined to form Kraft General Foods Inc., which was renamed Kraft Foods Inc. in 1995. In 2000, Philip Morris acquired Nabisco Holdings and began integrating Nabisco and Kraft. The story does not end here. In August 2008, the Post Cereal portion of Kraft was spun off and merged with Ralcorp Holdings. The remaining portion of Kraft Foods Inc. is the company that took part in the 2010 acquisition of Cadbury PLC.

Of course, this is only half of the story. Cadbury took its own journey. It took 104 years and dozens of mergers and acquisitions to finally end up with the companies that took part in this acquisition.

At the time of this writing, a mere eighteen months following the Cadbury acquisition, Kraft announced plans to spin off its $32 billion snack business by the end of 2012. This spin-off would separate the high-growth snack business from the North American grocery business ($16 billion in annual sales), which is focused in more mature markets. Analysts suggest that this spin-off will allow Kraft to separate two very distinct businesses that face different opportunities and challenges.

The business world is complex and frequent business combinations will continue to increase the complex nature of the business environment in the future. An understanding of the accounting treatment of mergers, acquisitions, and other intercorporate investments is an invaluable asset in our ever-changing markets. This chapter introduces the key concepts associated with business combinations.

LEARNING OBJECTIVES

When you finish studying this chapter, you should be able to:

- LO 1-1 Understand and explain the reasons for and different methods of business expansion, the types of organizational structures, and the types of acquisitions.
- LO 1-2 Understand the history of the development of standards related to acquisition accounting over time.
- LO 1-3 Make calculations and prepare journal entries for the creation and purchase of a business entity.
- LO 1-4 Understand and explain the differences between different forms of business combinations.
- LO 1-5 Make calculations and business combination journal entries in the presence of a differential, goodwill, or a bargain purchase element.
- LO 1-6 Understand additional considerations associated with business combinations.

AN INTRODUCTION TO COMPLEX BUSINESS STRUCTURES

LO 1-1

Understand and explain the reasons for and different methods of business expansion, the types of organizational structures, and the types of acquisitions.

The business environment in the United States is perhaps the most dynamic and vibrant in the world, characterized by rapid change and exceptional complexity. In this environment, regulators and standard setters such as the Securities and Exchange Commission (SEC), the Financial Accounting Standards Board (FASB), and the Public Company Accounting Oversight Board (PCAOB) are scrambling to respond to the rapid-paced changes in a manner that ensures the continued usefulness of accounting reports to reflect economic reality. A number of accounting and reporting issues arise when two or more companies join under common ownership or a company creates a complex organizational structure involving any of a variety of forms of new financing or operating entities. The first 10 chapters of this text focus on a number of these issues. Chapter 1 lays the foundation by describing some of the factors that have led to corporate expansion and some of the types of complex organizational structures and relationships that have evolved. Then it describes the accounting and reporting issues related to formal business combinations. Chapter 2 focuses on investments in the common stock of other companies and on selected other types of investments in and relationships with other entities. Moreover, it introduces basic concepts associated with the preparation of ***consolidated financial statements*** that portray the related companies as if they were actually a single company. The next eight chapters systematically explain additional details related to the preparation and use of consolidated financial statements.

Enterprise Expansion

Most business enterprises seek to expand over time in order to survive and become profitable. Both the owners and managers of a business enterprise have an interest in seeing a company grow in size. Increased size often allows economies of scale in both production and distribution. By expanding into new markets or acquiring other companies already in those markets, companies can develop new earning potential and those in cyclical industries can add greater stability to earnings through diversification. For example, in 1997, Boeing, a company very strong in commercial aviation, acquired McDonnell Douglas, a company weak in commercial aviation but very strong in military aviation and other defense and space applications. When orders for commercial airliners plummeted following a precipitous decline in air travel, increased defense spending, partially related to the war in Iraq, helped level out Boeing's earnings.

Business Objectives

Complex organizational structures often evolve to help achieve a business's objectives, such as increasing profitability or reducing risk. For example, many companies establish subsidiaries to conduct certain business activities. A ***subsidiary*** is a corporation that another corporation, referred to as a ***parent company,*** controls, usually through majority ownership of its common stock. Because a subsidiary is a separate legal entity, the parent's risk associated with the subsidiary's activities is limited. There are many reasons for creating or acquiring a subsidiary. For example, companies often transfer their receivables to subsidiaries or special-purpose entities that use the receivables as collateral for bonds issued to other entities (securitization). External parties may hold partial or complete ownership of those entities, allowing the transferring company to share its risk associated with the receivables. In some situations, companies can realize tax benefits by conducting certain activities through a separate entity. Bank of America, for example, established a subsidiary to which it transferred bank-originated loans and was able to save $418 million in quarterly taxes.[1]

Frequency of Business Combinations

Very few major companies function as single legal entities in our modern business environment. Virtually all major companies have at least one subsidiary, with more than a few broadly diversified companies having several hundred subsidiaries. In some cases, subsidiaries are created to incorporate separately part of the ongoing operations previously conducted within the parent company. Other subsidiaries are acquired through business combinations.

Business combinations are a continuing and frequent part of the business environment. A merger boom occurred in the 1960s. This period was characterized by frantic and, in some cases, disorganized merger binges, resulting in creation of a large number of conglomerates, or companies operating in many different industries. Because many of the resulting companies lacked coherence in their operations, they often were less successful than anticipated, and many of the acquisitions of the 1960s have since been sold or abandoned. In the 1980s, the number of business combinations again increased. That period saw many leveraged buyouts (when an acquiring company borrows the funds to buy another company), but the resulting debt has plagued many of those companies over the years.

The number of business combinations through the 1990s dwarfed previous merger booms, with all records for merger activity shattered. This pace continued into the new century, with a record-setting $3.3 trillion in deals closed in 2000.[2] However, with the

[1] "PNC Shakes Up Banking Sector; Investors Exit," *The Wall Street Journal,* January 30, 2002, p. C2.

[2] Dennis K. Berman and Jason Singer, "Big Mergers Are Making a Comeback as Companies, Investors Seek Growth," *The Wall Street Journal,* November 5, 2005, p. A1.

downturn in the economy in the early 2000s, the number of mergers declined significantly. Many companies put their expansion plans on hold, and a number of the mergers that did occur were aimed at survival. Toward the middle of 2003, merger activity again increased and accelerated significantly through the middle of the decade. During one period of less than 100 hours in 2006, "around $110 billion in acquisition deals were sealed worldwide in sectors ranging from natural gas, to copper, to mouthwash to steel, linking investors and industrialists from India, to Canada, to Luxembourg to the U.S."[3]

Through much of the 1990s, merger activity was fueled by a new phenomenon, the use of *private equity* money. Rather than the traditional merger activity that typically involves one publicly held company acquiring another, groups of investors—such as wealthy individuals, pension and endowment funds, and mutual funds—pooled their money to make acquisitions. Most of these acquisitions did not result in lasting ownership relationships, with the private equity companies usually attempting to realize a return by selling their investments in a relatively short time. This activity was slowed dramatically by the credit crunch of 2007–2008. Nevertheless, business combinations will continue to be an important business activity into the foreseeable future.

Aside from private-equity acquisitions, business combinations have been common in telecommunications, defense, banking and financial services, information technology, energy and natural resources, entertainment, pharmaceuticals, and manufacturing. Some of the world's largest companies and best-known names have been involved in recent major acquisitions, such as Procter & Gamble, Gillette, Citigroup, Bank of America, AT&T, Whirlpool, Sprint, Verizon, Adobe Systems, Chrysler, Daimler, ConocoPhillips, BP, and ExxonMobil.

FYI

Historically, mergers have come in waves as indicated by the following summary:

Period	Name	Facet
1897–1904	First Wave	Horizontal mergers
1916–1929	Second Wave	Vertical mergers
1965–1969	Third Wave	Diversified conglomerate mergers
1981–1989	Fourth Wave	Congeneric mergers; hostile takeovers; corporate raiding, LBO
1992–2000	Fifth Wave	Cross-border mergers
2003–2008	Sixth Wave	Shareholder activism, private equity, LBO

Source: Martin Lipton, "Merger Waves in the 19th, 20th and 21st Centuries," *The Davies Lecture*, York University, September 14, 2006."

Ethical Considerations

Acquisitions can sometimes lead to ethical challenges for managers. Corporate managers are often rewarded with higher salaries as their companies increase in size. In addition, prestige frequently increases with the size of a company and with a reputation for the successful acquisition of other companies. As a result, corporate managers often find it personally advantageous to increase company size. For instance, Bernard Ebbers started his telecommunications career as the head of a small discount long-distance telephone service company and built it into one of the world's largest corporations, WorldCom. In the process, Ebbers became well known for his acquisition prowess and grew tremendously wealthy—until WorldCom was racked by accounting scandals and declared bankruptcy and Ebbers was sentenced to prison in 2003.

Acquisitions and complex organizational structures have sometimes been used to manipulate financial reporting with the aim of enhancing or enriching managers. Many major corporations, taking advantage of loopholes or laxness in financial reporting requirements, have used subsidiaries or other entities to borrow large amounts of money without reporting the debt on their balance sheets. Some companies have created special entities that have then been used to manipulate profits.

The term *special-purpose entity* has become well known in recent years because of the egregious abuse of these entities by companies such as Enron. A ***special-purpose entity*** (SPE) is, in general, a financing vehicle that is not a substantive operating entity, usually

[3] Dennis K. Berman and Jason Singer, "Blizzard of Deals Heralds an Era of Megamergers," *The Wall Street Journal,* June 27, 2006, p. A1.

one created for a single specified purpose. An SPE may be in the form of a corporation, trust, or partnership. Enron Corp., one of the world's largest companies prior to its collapse in 2001, established many SPEs, at least some of which were intended to manipulate financial reporting. Some of Enron's SPEs apparently were created primarily to hide debt, and others were used to create fictional transactions or to convert borrowings into reported revenues.

Accounting for mergers and acquisitions also is an area that can lend itself to manipulation. Arthur Levitt, former chairman of the SEC, referred to some of the accounting practices that have been used in accounting for mergers and acquisitions as "creative acquisition accounting" or "merger magic." For example, an approach used by many companies in accounting for their acquisitions was to assign a large portion of the purchase price of an acquired company to its in-process research and development, immediately expensing the full amount and freeing financial reporting in future periods from the burden of those costs. The FASB has since eliminated this practice. However, the frequency and size of business combinations, the complexity of accounting, and the potential impact on financial statements of the accounting methods employed mean that the issues surrounding the accounting for business combinations are still of critical importance.

The scandals and massive accounting failures at companies such as Enron, WorldCom, and Tyco—leading creditors, investors, employees, and others to suffer heavy losses—focused considerable attention on weaknesses in accounting and the accounting profession. In the past several years, Congress, the SEC, and the FASB have taken actions to strengthen the financial reporting process and to clarify the accounting rules relating to special entities and to acquisitions.

BUSINESS EXPANSION AND FORMS OF ORGANIZATIONAL STRUCTURE

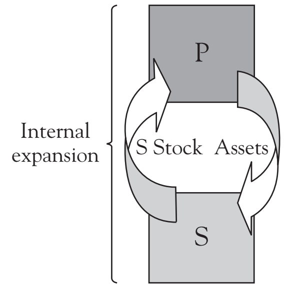
Historically, businesses have expanded by internal growth through new product development and expansion of existing product lines into new markets. In recent decades, however, many companies have chosen to expand by combining with or acquiring other companies. Either approach may lead to a change in organizational structure.

Internal Expansion: Creating a Business Entity

As companies expand from within, they often find it advantageous to conduct their expanded operations through new subsidiaries or other entities such as partnerships, joint ventures, or special entities. In most of these situations, an identifiable segment of the company's existing assets is transferred to the new entity, and, in exchange, the transferring company receives equity ownership (as illustrated in the diagram on the next page).

Companies may be motivated to establish new subsidiaries or other entities for a variety of reasons. Broadly diversified companies may place unrelated operations in separate subsidiaries to establish clear lines of control and facilitate the evaluation of operating results. In some cases, an entity that specializes in a particular type of activity or has its operations in a particular country may qualify for special tax incentives. Of particular importance in some industries is the fact that a separate legal entity may be permitted to operate in a regulatory environment without subjecting the entire entity to regulatory control. Also, by creating a separate legal entity, a parent company may be able to protect itself from exposing the entire company's assets to legal liability that may stem from a new product line or entry into a higher-risk form of business activity.

Companies also might establish new subsidiaries or other entities, not as a means of expansion, but as a means of disposing of a portion of their existing operations through outright sale or a transfer of ownership to existing shareholders or others. In some cases, companies have used this approach in disposing of a segment of operations that no longer fits well with the overall mission of the company. In other cases, this



approach has been used as a means of disposing of unprofitable operations or to gain regulatory or shareholder approval of a proposed merger with another company. A ***spin-off*** occurs when the ownership of a newly created or existing subsidiary is distributed to the parent's stockholders without the stockholders surrendering any of their stock in the parent company. Thus, the company divests itself of the subsidiary because it is owned by the company's shareholders after the spin-off. A ***split-off*** occurs when the subsidiary's shares are exchanged for shares of the parent, thereby leading to a reduction in the parent company's outstanding shares. Although the two divestiture types are similar, the split-off could result in one set of the former parent shareholders exchanging their shares for those of the divested subsidiary. Although a transfer of ownership to one or more unrelated parties normally results in a taxable transaction, properly designed transfers of ownership to existing shareholders generally qualify as nontaxable exchanges.

FYI

As of this writing (March 2012), Kraft is planning to spin off its $32 billion snack business, presumably as a means of allowing Kraft to focus on its grocery business and other strategic goals.

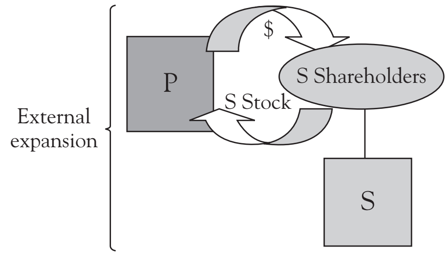
External Expansion: Business Combinations

Many times companies find that entry into new product areas or geographic regions is more easily accomplished by acquiring or combining with other companies than through internal expansion. For example, SBC Communications, a major telecommunications company and one of the "Baby Bells," significantly increased its service area by combining with Pacific Telesis and Ameritech, later acquiring AT&T (and adopting its name), and subsequently combining with BellSouth. Similarly, because the state of Florida has traditionally been very reluctant to issue new bank charters, bank corporations wishing to establish operations in Florida have had to acquire an existing bank to obtain a charter in the state.

A ***business combination*** occurs when ". . . an acquirer obtains control of one or more businesses."[4] The diagram on the next page illustrates a typical acquisition. The concept of ***control*** relates to the ability to direct policies and management. Traditionally, control over a company has been gained by acquiring a majority of the company's common stock. However, the diversity of financial and operating arrangements employed in recent years also raises the possibility of gaining control with less than majority ownership or, in some cases, with no ownership at all through other contractual arrangements.

The types of business combinations found in today's business environment and the terms of the combination agreements are as diverse as the firms involved. Companies enter into various types of formal and informal arrangements that may have at least some of the characteristics of a business combination. Most companies tend to avoid recording informal agreements on their books because of the potential difficulty of enforcing them. In fact, some types of informal arrangements, such as those aimed at fixing prices or apportioning potential customers, are illegal. Formal agreements generally are enforceable and are more likely to be recognized on the books of the participants.

[4] **ASC 805-10-65-1.**



Organizational Structure and Financial Reporting

When companies expand or change organizational structure by acquiring other companies or through internal division, the new structure must be examined to determine the appropriate financial reporting procedures. Several approaches are possible, depending on the circumstances:

1. **Merger** A merger is a business combination in which the acquired company's assets and liabilities are combined with those of the acquiring company. Thus, two companies are merged into a single entity. In essence, the acquiring company "swallows" the acquired company.
2. **Controlling ownership** A business combination in which the acquired company remains as a separate legal entity with a majority of its common stock owned by the purchasing company leads to a parent–subsidiary relationship. Accounting standards normally require that the financial statements of the parent and subsidiary be consolidated for general-purpose reporting so the companies appear as a single company. The treatment is the same if the subsidiary is created rather than purchased. The treatment is also the same when the other entity is unincorporated and the investor company has control and majority ownership.[5]
3. **Noncontrolling ownership** The purchase of a less-than-majority interest in another corporation does not usually result in a business combination or controlling situation. A similar situation arises when a company creates another entity and holds less than a controlling position in it or purchases a less-than-controlling interest in an existing partnership. In its financial statements, the investor company reports its interest in the investee as an investment with the specific method of accounting for the investment dictated by the circumstances.
4. **Other beneficial interest** One company may have a beneficial interest in another entity even without a direct ownership interest. The beneficial interest may be defined by the agreement establishing the entity or by an operating or financing agreement. When the beneficial interest is based on contractual arrangements instead of majority stock ownership, the reporting rules may be complex and depend on the circumstances. In general, a company that has the ability to make decisions significantly affecting the results of another entity's activities or is expected to receive a majority of the other entity's profits and losses is considered to be that entity's ***primary beneficiary.*** Normally, that entity's financial statements would be consolidated with those of the primary beneficiary.

These different situations, and the related accounting and reporting procedures, will be discussed throughout the first 10 chapters of the text. The primary focus will be on the first three situations, especially the purchase of all or part of another company's stock. The discussion of the fourth situation in Chapter 3 will be limited because of its complexity and the diversity of these contractual arrangements.

[5] Majority ownership is generally a sufficient but not a necessary condition for the indicated treatment. Unlike the corporate case, percentage ownership does not fully describe the nature of a beneficial interest in a partnership. Investments in partnerships are discussed in later chapters.

THE DEVELOPMENT OF ACCOUNTING FOR BUSINESS COMBINATIONS

LO 1-2

Understand the history of the development of standards related to acquisition accounting over time.

For more than half a century, accounting for business combinations remained largely unchanged. Two methods of accounting for business combinations, *the purchase method* and the ***pooling-of-interests method,*** were acceptable during that time. However, major changes in accounting for business combinations have occurred over the past decade. First, the FASB eliminated the pooling-of-interests method in 2001, leaving only a single method, purchase accounting. Then, in 2007, the FASB issued the revised standard (**ASC 805**) that replaced the purchase method with the *acquisition method,* which is now the only acceptable method of accounting for business combinations.

Although all business combinations must now be accounted for using the acquisition method, many companies' financial statements will continue to include the effects of previous business combinations recorded using the pooling-of-interests method. Thus, a general understanding of this method can be helpful.

The idea behind a pooling of interests was that no change in ownership had actually occurred in the business combination, often a questionable premise. Based on this idea, the book values of the combining companies were carried forward to the combined company and no revaluations to fair value were made. Managers often preferred pooling accounting because it did not result in asset write-ups or goodwill that might burden future earnings with additional depreciation or write-offs. Also, reporting practices often made acquisitions appear better than they would have appeared if purchase accounting had been used.

Purchase accounting treated the purchase of a business much like the purchase of any asset. The acquired company was recorded based on the purchase price that the acquirer paid. Individual assets and liabilities of the acquired company were valued at their fair values, and the difference between the total purchase price and the fair value of the net identifiable assets acquired was recorded as goodwill. All direct costs of bringing about and consummating the combination were included in the total purchase price.

Acquisition accounting is consistent with the FASB's intention to move accounting in general more toward recognizing fair values. Under acquisition accounting, the acquirer in a business combination, in effect, values the acquired company based on the fair value of the consideration given in the combination and the fair value of any noncontrolling interest not acquired by the acquirer.

ACCOUNTING FOR INTERNAL EXPANSION: CREATING BUSINESS ENTITIES[6]

LO 1-3

Make calculations and prepare journal entries for the creation and purchase of a business entity.

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Companies that choose to conduct a portion of their operations through separate business entities usually do so through corporate subsidiaries, corporate joint ventures, or partnerships. The ongoing accounting and reporting for investments in corporate joint ventures and subsidiaries are discussed in Chapters 2 through 10. This section discusses the origination of these entities when the parent or investor creates them rather than purchases an interest in an existing corporation or partnership.

When a company transfers assets or operations to another entity that it has created, a vast number of variations in the types of entities and the types of agreements between the creating company and the created entity are possible. Accordingly, it is impossible to establish a single set of rules and procedures that will suffice in all situations. We focus on the most straightforward and common cases in which the

[6] To view a video explanation of this topic, visit advancedstudyguide.com.

transferring company creates a subsidiary or partnership that it owns and controls, including cases in which the company intends to transfer ownership to its stockholders through a spin-off or split-off. In simple cases, the company transfers assets, and perhaps liabilities, to an entity that the company has created and controls and in which it holds majority ownership. The company transfers assets and liabilities to the created entity at book value, and the transferring company recognizes an ownership interest in the newly created entity equal to the book value of the net assets transferred. Recognition of fair values of the assets transferred in excess of their carrying values on the books of the transferring company normally is not appropriate in the absence of an arm's-length transaction. Thus, no gains or losses are recognized on the transfer by the transferring company. However, if the value of an asset transferred to a newly created entity has been impaired prior to the transfer and its fair value is less than the carrying value on the transferring company's books, the transferring company should recognize an impairment loss and transfer the asset to the new entity at the lower fair value.

FYI

An "arm's-length transaction" is one in which the parties are completely independent of one another so that they act in their personal best interests or to maximize their own wealth. Thus, there is no chance of collusion between them.

The created entity begins accounting for the transferred assets and liabilities in the normal manner based on their book values at the time of transfer. Subsequent financial reporting involves consolidating the created entity's financial statements with those of the parent company. Overall, the consolidated financial statements appear the same as if the transfer had not taken place.

As an illustration of a created entity, assume that Allen Company creates a subsidiary, Blaine Company, and transfers the following assets to Blaine in exchange for all 100,000 shares of Blaine's $2 par common stock:

Item	Cost	Book Value
Cash		$ 70,000
Inventory	$ 50,000	50,000
Land	75,000	75,000
Building	100,000	80,000
Equipment	250,000	160,000
		$435,000

Allen records the transfer with the following entry:[7]

(1)	Investment in Blaine Company Common Stock	435,000	
	Accumulated Depreciation*	110,000	
	Cash		70,000
	Inventory		50,000
	Land		75,000
	Building		100,000
	Equipment		250,000

Record the creation of Blaine Company.
*$110,000 = ($100,000 − $80,000) + ($250,000 − $160,000)

[7] Journal entries used in the text to illustrate the various accounting procedures are numbered sequentially within individual chapters for easy reference. Each journal entry number appears only once in a chapter.

Blaine Company records the transfer of assets and the issuance of stock (at the book value of the assets) as follows:

(2)

Cash	70,000	
Inventory	50,000	
Land	75,000	
Building	100,000	
Equipment	250,000	
Accumulated Depreciation		110,000
Common Stock, $2 par		200,000
Additional Paid-In Capital		235,000

Record the receipt of assets and the issuance of $2 par common stock.

ACCOUNTING FOR EXTERNAL EXPANSION: BUSINESS COMBINATIONS

LO 1-4

Understand and explain the differences between different forms of business combinations.

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A business combination occurs when one party acquires control over one or more businesses. This usually involves two or more separate businesses being joined together under common control. The acquirer may obtain control by paying cash, transferring other assets, issuing debt, or issuing stock. In rare cases, the acquirer might obtain control by agreement or through other means without an exchange taking place. Business combinations can take one of several different forms and can be effected in different ways.

Forms of Business Combinations

Figure 1–1 illustrates the three primary legal forms of business combinations. A ***statutory merger*** is a type of business combination in which only one of the combining companies survives and the other loses its separate identity. The acquired company's assets and liabilities are transferred to the acquiring company, and the acquired company is dissolved, or ***liquidated.*** The operations of the previously separate companies are carried on in a single legal entity following the merger.

A ***statutory consolidation*** is a business combination in which both combining companies are dissolved and the assets and liabilities of both companies are transferred to a newly created corporation. The operations of the previously separate companies are carried on in a single legal entity, and neither of the combining companies remains in existence after a statutory consolidation. In many situations, however, the resulting corporation is new in form only, and in substance it actually is one of the combining companies reincorporated with a new name.

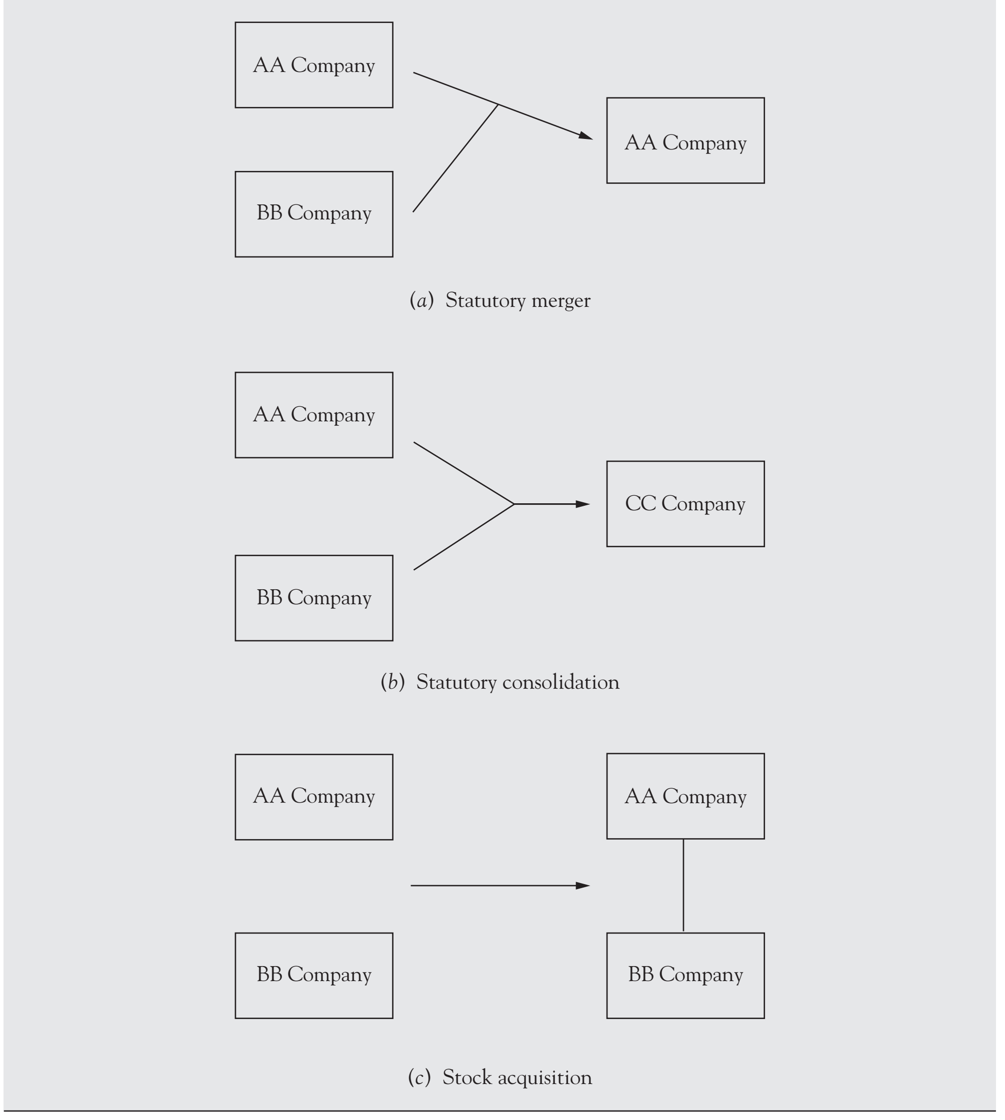
A ***stock acquisition*** occurs when one company acquires the voting shares of another company and the two companies continue to operate as separate, but related, legal entities. Because neither of the combining companies is liquidated, the acquiring company accounts for its ownership interest in the other company as an investment. In a stock acquisition, the acquiring company need not acquire all the other company's stock to gain control. The relationship that is created in a stock acquisition is referred to as a ***parent–subsidiary relationship.*** A *parent company* is one that controls another company, referred to as a *subsidiary,* usually through majority ownership of common stock. For general-purpose financial reporting, a parent company and its subsidiaries present consolidated financial statements that appear largely as if the companies had actually merged into one.

The legal form of a business combination, the substance of the combination agreement, and the circumstances surrounding the combination all affect how the combination is recorded initially and the accounting and reporting procedures used subsequent to the combination.

Methods of Effecting Business Combinations

Business combinations can be characterized as either friendly or unfriendly. In a friendly combination, the managements of the companies involved come to agreement on the terms of the combination and recommend approval by the stockholders. Such combinations usually are effected in a single transaction involving an exchange of assets or voting

FIGURE 1–1
Types of Business Combinations



shares. In an unfriendly combination, or "hostile takeover," the managements of the companies involved are unable to agree on the terms of a combination, and the management of one of the companies makes a ***tender offer*** directly to the shareholders of the other company to buy their stock at a specified price. A tender offer invites the shareholders of the other company to "tender," or exchange, their shares for securities or assets of the acquiring company. If sufficient shares are tendered, the acquiring company gains voting control of the other company and can install its own management by exercising its voting rights.

The specific procedures to be used in accounting for a business combination depend on whether the combination is effected through an acquisition of assets or an acquisition of stock.

Acquisition of Assets

Sometimes one company acquires another company's assets through direct negotiations with its management. The agreement also may involve the acquiring company's assuming the other company's liabilities. Combinations of this sort normally take form (*a*) or form (*b*) in Figure 1–1. The selling company generally distributes to its stockholders the assets or securities received in the combination from the acquiring company and liquidates, leaving only the acquiring company as the surviving legal entity.

STOP & THINK

Can you name the ten largest and best-known North American merger and acquisition transactions? They've all happened in your lifetime!

Rank	Year	Acquirer	Target	Transaction Value (in bil. USD)
1	2000	America Online Inc.	Time Warner Inc.	164.7
2	1999	Pfizer Inc.	Warner-Lambert Co.	89.2
3	1998	Exxon Corp.	Mobil Corp.	78.9
4	2006	AT&T Inc.	BellSouth Corp.	72.7
5	1998	Travelers Group Inc.	Citicorp	72.6
6	2001	Comcast Corp.	AT&T Broadband & Internet Services	72.0
7	2009	Pfizer Inc.	Wyeth Corp.	67.3
8	1998	SBC Communications Inc.	Ameritech Corp.	62.6
9	1998	NationsBank Corp., Charlotte, NC	BankAmerica Corp.	61.6
10	1999	Vodafone Group PLC	AirTouch Communications Inc.	60.3

Source: Institute of Mergers, Acquisitions and Alliances.

The acquiring company accounts for the combination by recording each asset acquired, each liability assumed, and the consideration given in exchange at fair value.

Acquisition of Stock

A business combination effected through a stock acquisition does not necessarily have to involve the acquisition of all of a company's outstanding voting shares. For one company to gain control over another through stock ownership, a majority (i.e., more than 50 percent) of the outstanding voting shares usually is required unless other factors lead to the acquirer's gaining control. The total of the shares of an acquired company not held by the controlling shareholder is called the ***noncontrolling interest.*** In the past, the noncontrolling interest was referred to as the ***minority interest.***

In those cases when control of another company is acquired and both companies remain in existence as separate legal entities following the business combination, the stock of the acquired company is recorded on the books of the acquiring company as an investment.

Acquisition by Other Means

Occasionally, a business combination may be effected without an exchange of assets or equities and without a change in ownership. In some cases, control might be acquired through agreement alone.

Valuation of Business Entities

All parties involved in a business combination must believe they have an opportunity to benefit before they will agree to participate. Determining whether a particular combination proposal is advantageous can be difficult. Both the value of a company's assets and its future earning potential are important in assessing the value of the company. Tax laws also influence investment decisions. For example, the existence of accumulated net operating losses that can be used under U.S. tax law to shelter future income from taxes increases the value of a potential acquiree.

Value of Individual Assets and Liabilities

The value of a company's individual assets and liabilities is usually determined by appraisal. For some items, the value may be determined with relative ease, such as investments that are traded actively in the securities markets or short-term payables. For other items, the appraisal may be much more subjective, such as the value of land located in an area where few recent sales have occurred. In addition, certain intangibles typically are not reported on the balance sheet. For example, the costs of developing new ideas, new products, and new production methods normally are expensed as research and development costs in the period incurred.

Current liabilities are often viewed as having fair values equal to their book values because they will be paid at face amount within a short time. Long-term liabilities, however, must be valued based on current interest rates if different from the effective rates at the issue dates of the liabilities. For example, if \$100,000 of 10-year, 6 percent bonds, paying interest annually, had been issued at par three years ago, and the current market rate of interest for the same type of security is 10 percent, the value of the liability currently is computed as follows:

Present value for 7 years at 10% of principal payment of $100,000	$51,316
Present value at 10% of 7 interest payments of $6,000	29,211
Present value of bond	$80,527

Although accurate assessments of the value of assets and liabilities may be difficult, they form an important part of the overall determination of the value of an enterprise.

Value of Potential Earnings

In many cases, assets operated together as a group have a value that exceeds the sum of their individual values (i.e., there is unrecorded goodwill). This “going-concern value” makes it desirable to operate the assets as an ongoing entity rather than sell them individually. A company’s earning power as an ongoing enterprise is of obvious importance in valuing that company.

There are different approaches to measuring the value of a company’s future earnings. Sometimes companies are valued based on a multiple of their current earnings. For example, if Bargain Company reports earnings of $35,000 for the current year, the company’s value based on a multiple of 10 times current earnings is $350,000. The appropriate multiple to use is a matter of judgment and is based on factors such as the riskiness and variability of the earnings and the anticipated degree of growth.

Another method of valuing a company is to compute the present value of the anticipated future net cash flows generated by the company. This requires assessing the amount and timing of future cash flows and discounting them back to the present value at the discount rate determined to be appropriate for the type of enterprise. For example, if Bargain Company is expected to generate cash flows of $35,000 for each of the next 25 years, the present value of the firm at a discount rate of 10 percent is $317,696. Estimating the potential for future earnings requires numerous assumptions and estimates. Not surprisingly, the buyer and seller often have difficulty agreeing on the value of a company’s expected earnings.

Valuation of Consideration Exchanged

When one company acquires another, the acquiring company must place a value on the consideration given in the exchange. Little difficulty is encountered when the acquiring company gives cash in an acquisition, but valuation may be more difficult when the acquiring company gives securities, particularly new untraded securities or securities with unusual features. For example, General Motors completed an acquisition a number of years ago using a new Series B common stock that paid dividends based on subsequent earnings of the acquired company rather than on the earnings of General Motors as a whole. Some companies have used non-interest-bearing bonds (zero coupon bonds), which have a fair value sufficiently below par value to compensate the holder for interest. Other companies have used various types of convertible securities. Unless these securities, or others that are considered equivalent, are being traded in the market, estimates of their value must be made. The approach generally followed is to use the value of some similar security with a determinable market value and adjust for the estimated value of the differences in the features of the two securities.

ACQUISITION ACCOUNTING

LO 1-5

Make calculations and business combination journal entries in the presence of a differential, goodwill, or a bargain purchase element.

As of the end of 2007, the FASB significantly changed the method of accounting for business combinations, requiring the use of the ***acquisition method.*** Under the acquisition method, the acquirer recognizes all assets acquired and liabilities assumed in a business combination and measures them at their acquisition-date fair values. If less than 100 percent of the acquiree is acquired, the noncontrolling interest also is measured at its acquisition-date fair value. Note that a business combination does not affect the amounts at which the assets and liabilities of the acquirer are valued.

Fair Value Measurements

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Because accounting for business combinations is now based on fair values, the measurement of fair values takes on added importance. The acquirer must value at fair value (1) the consideration it exchanges in a business combination, (2) each of the individual identifiable assets and liabilities acquired, and (3) any noncontrolling interest in the acquiree. Normally, a business combination involves an arm's-length exchange between two unrelated parties. The value of the consideration given in the exchange is usually the best measure of the value received and, therefore, reflects the value of the acquirer's interest in the acquiree. However, the FASB decided in **ASC 805** to focus directly on the value of the consideration given rather than just using it to impute a fair value for the acquiree as a whole. In some cases, the value of the consideration given may be difficult to determine, or there may be no exchange, and valuation is better based on the value of the acquirer's interest in the acquiree or other valuation techniques. **ASC 820** provides a framework for applying fair value measurements in accounting.

Applying the Acquisition Method

For all business combinations, an acquirer must be identified, and that party is the one gaining control over the other. In addition, an acquisition date must be determined. That date is usually the closing date when the exchange transaction actually occurs. However, in rare cases control may be acquired on a different date or without an exchange, so the circumstances must be examined to determine precisely when the acquirer gains control.

Under the acquisition method, the full acquisition-date fair values of the individual assets acquired, both tangible and intangible, and liabilities assumed in a business combination are recognized. This is true regardless of the percentage ownership acquired by the controlling entity. If the acquirer acquires all of the assets and liabilities of the acquiree in a merger, these assets and liabilities are recorded on the books of the acquiring company at their acquisition-date fair values. If the acquiring company acquires partial ownership of the acquiree in a stock acquisition, the assets acquired and liabilities assumed appear at their full acquisition-date fair values in a consolidated balance sheet prepared immediately after the combination.

All indirect costs of bringing about and consummating a business combination are charged to an acquisition expense as incurred. Examples of traceable, indirect costs include finders' fees, consulting fees, travel costs, and so on. The costs of issuing equity securities used to acquire the acquiree are treated in the same manner as stock issues costs are normally treated, as a reduction in the paid-in capital associated with the securities.

Goodwill

Conceptually, *goodwill* as it relates to business combinations consists of all those intangible factors that allow a business to earn above-average profits. From an accounting perspective, the FASB has stated that ***goodwill*** "is an asset representing the future economic benefits arising from other assets acquired in a business combination that are not individually identified and separately recognized" (**ASC 805-10-65-1**). An asset is considered to be *identifiable,* and therefore must be separately recognized, if it is separable (can be separated from the business) or arises from a contractual or other right.

Under the acquisition method, an acquirer measures and recognizes goodwill from a business combination based on the difference between the total fair value of the acquired company and the fair value of its net identifiable assets. However, the FASB decided, for several reasons, not to focus directly on the total fair value of the acquiree, but rather on the components that provide an indication

FYI

Kraft's $19.4 billion acquisition of Cadbury mentioned at the beginning of the chapter resulted in Kraft recording $9.53 billion in goodwill.

of that fair value. The FASB identified three components that should be measured and summed for the total amount to be used in determining the amount of goodwill recognized in a business combination:

1. The fair value of the consideration given by the acquirer.
2. The fair value of any interest in the acquiree already held by the acquirer, if any.
3. The fair value of the noncontrolling interest in the acquiree, if any.

The total of these three amounts, all measured at the acquisition date, is then compared with the acquisition-date fair value of the acquiree's net identifiable assets, and any excess is *goodwill*.

As an example of the computation of goodwill, assume that Albert Company acquires all of the assets of Zanfor Company for $400,000 when the fair value of Zanfor's net identifiable assets is $380,000. Goodwill is recognized for the $20,000 difference between the total consideration given and the fair value of the net identifiable assets acquired. If, instead of an acquisition of assets, Albert acquires 75 percent of the common stock of Zanfor for $300,000, and the fair value of the noncontrolling interest is $100,000, goodwill is computed as follows:

Fair value of consideration given by Albert	$300,000
+ Fair value of noncontrolling interest	100,000
Total fair value of Zanfor Company	$400,000
– Fair value of net identifiable assets acquired	(380,000)
Goodwill	$ 20,000

Note that the total amount of goodwill is not affected by whether 100 percent of the acquiree or less than that is acquired. However, the fair value of the noncontrolling interest does have an effect on the amount of goodwill recognized. In the example given, the fair values of the controlling and noncontrolling interests are proportional (each is valued at an amount equal to its proportionate ownership share of the total) and imply a total fair value of the acquired company of $400,000. This is frequently the case and will always be assumed throughout the text unless indicated otherwise. However, that may not always be the case in practice. Situations might arise in a stock acquisition, for example, where the per-share value of the controlling interest is higher than that of the noncontrolling interest because of a premium associated with gaining control.

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Combination Effected through the Acquisition of Net Assets

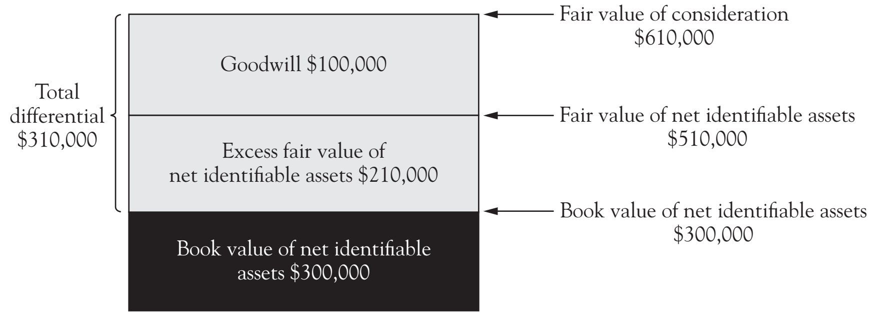
When one company acquires all the net assets of another in a business combination, the acquirer records on its books the individual assets acquired and liabilities assumed in the combination and the consideration given in exchange. Each identifiable asset and liability acquired is recorded by the acquirer at its acquisition-date fair value. The acquiring company records any excess of the fair value of the consideration exchanged over the fair value of the acquiree's net identifiable assets as goodwill.

To illustrate the application of the acquisition method of accounting to a business combination effected through the acquisition of the acquiree's net assets, assume that Point Corporation acquires all of the assets and assumes all of the liabilities of Sharp Company in a statutory merger by issuing 10,000 shares of $10 par common stock to Sharp. The shares issued have a total market value of $610,000. Point incurs legal and appraisal fees of $40,000 in connection with the combination and stock issue costs of $25,000. Figure 1–2 shows the book values and fair values of Sharp's individual assets and liabilities on the date of combination.

FIGURE 1–2
Sharp Company Balance Sheet Information, December 31, 20X0

Assets, Liabilities and Equities	Book Value	Fair Value
Cash & Receivables	$ 45,000	$ 45,000
Inventory	65,000	75,000
Land	40,000	70,000
Buildings & Equipment	400,000	350,000
Accumulated Depreciation	(150,000)	
Patent		80,000
Total Assets	$400,000	$620,000
Current Liabilities	$100,000	110,000
Common Stock ($5 par)	100,000	
Additional Paid-In Capital	50,000	
Retained Earnings	150,000	
Total Liabilities & Equities	$400,000	
Fair Value of Net Assets		$510,000

The relationships among the fair value of the consideration exchanged, the fair value of Sharp's net assets, and the book value of Sharp's net assets are illustrated in the following diagram:



The total difference at the acquisition date between the fair value of the consideration exchanged and the book value of the net identifiable assets acquired is referred to as the ***differential.*** In more complex situations, the differential is equal to the difference between (1) the acquisition-date fair value of the consideration transferred by the acquirer, plus the acquisition-date fair value of any equity interest in the acquiree previously held by the acquirer, plus the fair value of any noncontrolling interest in the acquiree and (2) the acquisition-date book values of the identifiable assets acquired and liabilities assumed.

In the Point/Sharp merger, the total differential of $310,000 reflects the difference between the total fair value of the shares issued by Point and the carrying amount of Sharp's net assets reflected on its books at the date of combination. A portion of that difference ($210,000) is attributable to the increased value of Sharp's net assets over book value. The remainder of the difference ($100,000) is considered to be goodwill.

The $40,000 of acquisition costs incurred by Point in carrying out the acquisition are expensed as incurred:

(3)	Acquisition Expense	40,000	
	Cash		40,000

Record costs related to acquisition of Sharp Company.

Portions of the $25,000 of stock issue costs related to the shares issued to acquire Sharp may be incurred at various times. To facilitate accumulating these amounts before recording the combination, Point may record them in a separate temporary "suspense" account as incurred:

(4)

Deferred Stock Issue Costs	25,000	
Cash		25,000

Record costs related to issuance of common stock.

On the date of combination, Point records the acquisition of Sharp with the following entry:

(5)

Cash and Receivables	45,000	
Inventory	75,000	
Land	70,000	
Buildings and Equipment	350,000	
Patent	80,000	
Goodwill	100,000	
Current Liabilities		110,000
Common Stock		100,000
Additional Paid-In Capital		485,000
Deferred Stock Issue Costs		25,000

Record acquisition of Sharp Company.

Entry (5) records all of Sharp's individual assets and liabilities, both tangible and intangible, on Point's books at their fair values on the date of combination. The fair value of Sharp's net assets recorded is \$510,000 (\$620,000 − \$110,000). The \$100,000 difference between the fair value of the shares given by Point (\$610,000) and the fair value of Sharp's net assets is recorded as goodwill.

In recording the business combination, Sharp's book values are not relevant to Point; only the fair values are recorded. Because a change in ownership has occurred, the basis of accounting used by the acquired company is not relevant to the acquirer. Consistent with this view, accumulated depreciation recorded by Sharp on its buildings and equipment is not relevant to Point and is not recorded.

The stock issue costs are treated as a reduction in the proceeds received from the issuance of the stock. Thus, these costs are transferred from the temporary account to Additional Paid-In Capital as a reduction. Point records the \$610,000 of stock issued at its value minus the stock issue costs, or \$585,000. Of this amount, the \$100,000 par value is recorded in the Common Stock account and the remainder in Additional Paid-In Capital.

Entries Recorded by Acquired Company

On the date of the combination, Sharp records the following entry to recognize receipt of the Point shares and the transfer of all individual assets and liabilities to Point:

(6)

Investment in Point Stock	610,000	
Current Liabilities	100,000	
Accumulated Depreciation	150,000	
Cash and Receivables		45,000
Inventory		65,000
Land		40,000
Buildings and Equipment		400,000
Gain on Sale of Net Assets		310,000

Record transfer of assets to Point Corporation.

Sharp recognizes the fair value of Point Corporation shares at the time of the exchange and records a gain of $310,000. The distribution of Point shares to Sharp shareholders and the liquidation of Sharp are recorded on Sharp's books with the following entry:

(7)	Common Stock	100,000	
	Additional Paid-In Capital	50,000	
	Retained Earnings	150,000	
	Gain on Sale of Net Assets	310,000	
	Investment in Point Stock		610,000
	Record distribution of Point Corporation stock.		

Subsequent Accounting for Goodwill by Acquirer

The acquirer records goodwill arising in a merger for the difference between the fair value of the consideration exchanged and the fair value of the identifiable net assets acquired, as illustrated in entry (5). Once the acquirer records goodwill, it must be accounted for in accordance with **ASC 350**. Goodwill is carried forward at the originally recorded amount unless it becomes impaired. Goodwill must be reported as a separate line item in the balance sheet. A goodwill impairment loss that occurs subsequent to recording goodwill must be reported as a separate line item within income from continuing operations in the income statement unless the loss relates to discontinued operations, in which case the loss is reported within the discontinued operations section.

Goodwill must be tested for impairment at least annually, at the same time each year, and more frequently if events that are likely to impair the value of the goodwill occur. The process of testing goodwill for impairment is complex. It involves examining potential goodwill impairment by each of the company's reporting units, where a reporting unit is an operating segment[8] or a component of an operating segment that is a business for which management regularly reviews financial information from that component. When goodwill arises in a business combination, it must be assigned to individual reporting units. The goodwill is assigned to units that are expected to benefit from the combination, even if no other assets or liabilities of the acquired company are assigned to those units. To test for the impairment of goodwill, the fair value of the reporting unit is compared with its carrying amount. If the fair value of the reporting unit exceeds its carrying amount, the goodwill of that reporting unit is considered unimpaired. On the other hand, if the carrying amount of the reporting unit exceeds its fair value, an impairment of the reporting unit's goodwill is implied.[9]

The amount of the reporting unit's goodwill impairment is measured as the excess of the carrying amount of the unit's goodwill over the implied value of its goodwill. The implied value of its goodwill is determined as the excess of the fair value of the reporting unit over the fair value of its net assets excluding goodwill. Goodwill impairment losses are recognized in income from continuing operations or included in gain/loss from discontinued operations, if related.

As an example of goodwill impairment, assume that Reporting Unit A is assigned $100,000 of goodwill arising from a recent business combination. The following assets and liabilities are assigned to Reporting Unit A:

[8] An operating segment is defined in **ASC 280-10-50**. Whereas U.S. GAAP assigns goodwill to reporting units, IFRS assigns goodwill to cash-generating units (GCU).

[9] The one-step impairment test for goodwill under IFRS is slightly different. The recoverable amount of the cash-generating unit (GCU) is compared with its carrying amount. Any impairment loss is recognized in operating results as the excess of the carrying amount over the recoverable amount. Impairment losses are recognized in operating results. If the impairment loss exceeds the book value of goodwill, the loss is allocated first to goodwill and then on a pro rata basis to the other assets of the CGU.

Item	Carrying Amount	Fair Value
Cash and receivables	$ 50,000	$ 50,000
Inventory	80,000	90,000
Equipment	120,000	150,000
Goodwill	100,000	
Total assets	$350,000	$290,000
Current payables	(10,000)	(10,000)
Net assets	$340,000	$280,000

By summing the carrying amounts of the assets and subtracting the carrying amount of the payables, the carrying amount of the reporting unit, including the goodwill, is determined to be $340,000. If the fair value of the reporting unit is estimated to be $360,000, no impairment of goodwill is indicated. On the other hand, if the fair value of the reporting unit is estimated to be $320,000, a second comparison must be made to determine the amount of any impairment loss. The implied value of Reporting Unit A's goodwill is determined by deducting the $280,000 fair value of the net assets, excluding goodwill, from the unit's $320,000 fair value. The $40,000 difference ($320,000 − $280,000) represents Reporting Unit A's implied goodwill. The impairment loss is measured as the excess of the carrying amount of the unit's goodwill ($100,000) over the implied value of the goodwill ($40,000), or $60,000. This goodwill impairment loss is combined with any impairment losses from other reporting units to determine the total impairment loss to be reported by the company as a whole. Goodwill is written down by the amount of the impairment loss. Once written down, goodwill may not be written up for recoveries.

Bargain Purchase

Occasionally, the fair value of the consideration given in a business combination, along with the fair value of any equity interest in the acquiree already held and the fair value of any noncontrolling interest in the acquiree, may be less than the fair value of the acquiree's net identifiable assets, resulting in a ***bargain purchase.*** This might occur, for example, with a forced sale.

When a bargain purchase occurs (rarely), the acquirer must take steps to ensure that all acquisition-date valuations are appropriate. If they are, the acquirer recognizes a gain at the date of acquisition for the excess of the amount of the net identifiable assets acquired and liabilities assumed as valued under **ASC 805,** usually at fair value, over the sum of the fair value of the consideration given in the exchange, the fair value of any equity interest in the acquiree held by the acquirer at the date of acquisition, and the fair value of any noncontrolling interest. Along with the amount of the gain, companies must disclose the operating segment where the gain is reported and the factors that led to the gain.

To illustrate accounting for a bargain purchase, assume that in the previous example of Point and Sharp, Point is able to acquire Sharp for $500,000 cash even though the fair value of Sharp's net identifiable assets is estimated to be $510,000. In this simple bargain-purchase case without an equity interest already held or a noncontrolling interest, the fair value of Sharp's net identifiable assets exceeds the consideration exchanged by Point, and, accordingly, a $10,000 gain attributable to Point is recognized.

In accounting for the bargain purchase (for cash) on Point's books, the following entry replaces previous entry (5):

(8)	Cash and Receivables	45,000	
	Inventory	75,000	
	Land	70,000	
	Buildings and Equipment	350,000	
	Patent	80,000	
	Cash		500,000
	Current Liabilities		110,000
	Gain on Bargain Purchase of Sharp Company		10,000

Record acquisition of Sharp Company.

ASC 805 does not state a treatment for the situation opposite to that of a bargain purchase, that is, an overpayment. Acquirers do not knowingly overpay for an acquisition. Any overpayment presumably would be the result of misinformation, and the overpayment would not be discovered until a later time. The FASB avoided this issue by basing the computation of goodwill on the consideration given by the acquirer rather than the acquiree's total fair value. Thus, any overpayment would be included in goodwill and presumably eliminated in future periods by testing for goodwill impairment.

Combination Effected through Acquisition of Stock

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Many business combinations are effected by acquiring the voting stock of another company rather than by acquiring its net assets. In such a situation, the acquired company continues to exist, and the acquirer records an investment in the common stock of the acquiree rather than its individual assets and liabilities. The acquirer records its investment in the acquiree's common stock at the total fair value of the consideration given in exchange. For example, if Point Corporation (*a*) exchanges 10,000 shares of its stock with a total market value of $610,000 for all of Sharp Company's shares and (*b*) incurs merger costs of $40,000 and stock issue costs of $25,000, Point records the following entries upon receipt of the Sharp stock:

(9)	Acquisition Expense	40,000	
	Deferred Stock Issue Costs	25,000	
	Cash		65,000

Record merger and stock issue costs related to acquisition of Sharp Company.

(10)	Investment in Sharp Stock	610,000	
	Common Stock		100,000
	Additional Paid-In Capital		485,000
	Deferred Stock Issue Costs		25,000

Record acquisition of Sharp Company stock.

When a business combination is effected through a stock acquisition, the acquiree may continue to operate as a separate company or it may lose its separate identity and be merged into the acquiring company. The accounting and reporting procedures for intercorporate investments in common stock when the acquiree continues in existence are discussed in the next nine chapters. If the acquired company is liquidated and its assets and liabilities are transferred to the acquirer, the dollar amounts recorded are identical to those in entry (5).

Financial Reporting Subsequent to a Business Combination

Financial statements prepared subsequent to a business combination reflect the combined entity beginning on the date of combination going forward to the end of the fiscal period. When a combination occurs during a fiscal period, income earned by the acquiree prior to the combination is not reported in the income of the combined enterprise. If the combined company presents comparative financial statements that include statements for periods before the combination, those statements include only the activities and financial position of the acquiring company, not those of the acquiree.

To illustrate financial reporting subsequent to a business combination, assume the following information for Point Corporation and Sharp Company:

	20X0	20X1
Point Corporation:		
Separate income (excluding any income from Sharp)	$300,000	$300,000
Shares outstanding, December 31	30,000	40,000
Sharp Company:		
Net income	$ 60,000	$ 60,000

Point Corporation acquires all of Sharp Company's stock at book value on January 1, 20X1, by issuing 10,000 shares of common stock. Subsequently, Point Corporation presents comparative financial statements for the years 20X0 and 20X1. The net income and earnings per share that Point presents in its comparative financial statements for the two years are as follows:

20X0:	
Net Income	$300,000
Earnings per Share ($300,000/30,000 shares)	$10.00
20X1:	
Net Income ($300,000 + $60,000)	$360,000
Earnings per Share ($360,000/40,000 shares)	$9.00

If Point Corporation had acquired Sharp Company in the middle of 20X1 instead of at the beginning, Point would include only Sharp's earnings subsequent to acquisition in its 20X1 income statement. If Sharp earned $25,000 in 20X1 before acquisition by Point and $35,000 after the combination, Point would report total net income for 20X1 of $335,000 ($300,000 + $35,000). Note that if the shares are issued in the middle of the year, the weighted-average shares used in the EPS calculation would change as well.

ADDITIONAL CONSIDERATIONS IN ACCOUNTING FOR BUSINESS COMBINATIONS

LO 1-6

Understand additional considerations associated with business combinations.

ASC 805 includes a number of requirements relating to specific items or aspects encountered in business combinations. A discussion of the more common situations follows.

Uncertainty in Business Combinations

Uncertainty affects much of accounting measurement but is especially prevalent in business combinations. Although uncertainty relates to many aspects of business combinations, three aspects of accounting for business combinations deserve particular attention: the measurement period, contingent consideration, and acquiree contingencies.

Measurement Period

One type of uncertainty in business combinations arises from the requirement to value at acquisition-date fair value the assets and liabilities acquired in a business combination, the acquirer's interest in the acquiree, any noncontrolling interest, and the consideration given. Because the acquirer may not have sufficient information available immediately to properly ascertain fair values, **ASC 805** allows for a period of time, called the ***measurement period,*** to acquire the necessary information. The measurement period ends once the acquirer obtains the necessary information about the facts as of the acquisition date, but may not exceed one year beyond the acquisition date.

Assets that have been provisionally recorded as of the acquisition date are retrospectively adjusted in value during the measurement period for new information that clarifies the acquisition-date value. Usually, the offsetting entry is to goodwill. Retrospective adjustments may not be made for changes in value that occur subsequent to the acquisition date.

As an illustration, assume that Baine Company acquires land in a business combination and provisionally records the land at its estimated fair value of $100,000. During the measurement period, Baine receives a reliable appraisal that the land was worth $110,000 at the acquisition date. Subsequently, during the same accounting period, a change in the zoning of a neighboring parcel of land reduces the value of the land acquired by Baine to

$75,000. Baine records the clarification of the acquisition-date fair value of the land and the subsequent impairment of value with the following entries:

(11)	Land	10,000	
	Goodwill		10,000
	Adjust acquisition-date value of land acquired in business combination.		
(12)	Impairment Loss	35,000	
	Land		35,000
	Recognize decline in value of land held.		

Contingent Consideration

Sometimes the consideration exchanged by the acquirer in a business combination is not fixed in amount, but rather is contingent on future events. For example, the acquiree and acquirer may enter into a *contingent-share agreement* whereby, in addition to an initial issuance of shares, the acquirer may agree to issue a certain number of additional shares for each percentage point by which the earnings number exceeds a set amount over the next five years. Thus, total consideration exchanged in the business combination is not known within the measurement period because the number of shares to be issued is dependent on future events.

ASC 805 requires contingent consideration in a business combination to be valued at fair value as of the acquisition date and classified as either a liability or equity. The right to require the return of consideration given that it is dependent on future events is classified as an asset. Contingent consideration classified as an asset or liability is remeasured each period to fair value and the change is recognized in income.[10] Contingent consideration classified as equity is not remeasured.

Acquiree Contingencies

Certain contingencies may relate to an acquiree in a business combination, such as pending lawsuits or loan guarantees made by the acquiree. Certainly, the acquirer considers such contingencies when entering into an acquisition agreement, and the accounting must also consider such contingencies. Under **ASC 805,** the acquirer must recognize all contingencies that arise from contractual rights or obligations and other contingencies if it is more likely than not that they meet the definition of an asset or liability at the acquisition date. The acquirer records these contingencies at acquisition-date fair value.

For all acquired contingencies, the acquirer should provide a description of each, disclose the amount recognized at the acquisition date, and describe the estimated range of possible undiscounted outcomes. Subsequently, the acquirer should disclose changes in the amounts recognized and in the range of possible outcomes.

In-Process Research and Development

In normal operations, research and development costs are required to be expensed as incurred except under certain limited conditions. When a company acquires valuable ongoing research and development projects from an acquiree in a business combination, a question arises as to whether these should be recorded as assets. The FASB concluded in **ASC 805** that these projects are assets and should be recorded at their acquisition-date fair values, even if they have no alternative use. These projects should be classified as having indefinite lives and, therefore, should not be amortized until completed or abandoned. They should be tested for impairment in accordance with current standards. Subsequent expenditures for the previously acquired research and development projects would normally be expensed as incurred.

[10] The treatment of contingent consideration under IFRS is slightly different. Although contingent consideration classified as an asset or liability will likely be a financial instrument measured at fair value with gains or losses recognized in profit or loss, if the asset or liability is not a financial instrument, it is accounted for in accordance with the standard provisions for that class of asset or liability (i.e., not necessarily at fair value).

Noncontrolling Equity Held Prior to Combination

In some cases, an acquirer may hold an equity interest in an acquiree prior to obtaining control through a business combination. The total amount of the acquirer's investment in the acquiree subsequent to the combination is equal to the acquisition-date fair value of the equity interest previously held and the fair value of the consideration given in the business combination. For example, if Lemon Company held 10 percent of Aide Company's stock with a fair value of $500,000 and Lemon acquired the remaining shares of Aide for $4,500,000 cash, Lemon's total investment is considered to be $5,000,000.

An acquirer that held an equity position in an acquiree immediately prior to the acquisition date must revalue that equity position to its fair value at the acquisition date and recognize a gain or loss on the revaluation. Suppose that Lemon's 10 percent investment in Aide has a book value of $300,000 and fair value of $500,000 at the date Lemon acquires the remaining 90 percent of Aide's stock. Lemon revalues its original investment in Aide to its $500,000 fair value and recognizes a $200,000 gain on the revaluation at the date it acquires the remaining shares of Aide. Lemon records the following entries on its books in connection with the acquisition of Aide:

(13)	Investment in Aide Company Stock	200,000	
	Gain on revaluation of Aide Company Stock		200,000
	Revalue Aide Company stock to fair value at date of business combination.		
(14)	Investment in Aide Company Stock	4,500,000	
	Cash		4,500,000
	Acquire controlling interest in Aide Company.		

Summary of Key Concepts

Business combinations and complex organizational structures are an important part of the global business scene. Many companies add organizational components by creating new corporations or partnerships through which to carry out a portion of their operations. In other cases, companies may enter into business combinations to acquire other companies through which to further their objectives.

When a company creates another corporation or a partnership through a transfer of assets, the book values of those assets are transferred to the new entity and no gain or loss is recognized. The creating company and the new entity will combine their financial statements for general-purpose financial reporting to appear as if they were a single company as long as the creating company continues to control the new entity.

Over the decades, business combinations have been occurring with increasing frequency. A business combination occurs when an acquirer obtains control of one or more other businesses. The three types of business combination that are commonly found are (*a*) statutory mergers in which the acquiree loses its separate identity and the acquirer continues with the assets and liabilities of both companies; (*b*) statutory consolidations in which both combining companies join to form a new company; and (*c*) stock acquisitions in which both combining companies maintain their separate identities, with the acquirer owning the stock of the acquiree.

ASC 805 requires that the acquisition method be used to account for business combinations. Under the acquisition method, all of the assets acquired and liabilities assumed by the acquirer in a business combination are valued at their fair values. The excess of the sum of the fair value of the acquirer's consideration transferred, the fair value of any equity interest in the acquiree already held, and the fair value of any noncontrolling interest in the acquiree over the fair value of the net identifiable assets acquired is goodwill. In subsequent financial statements, goodwill must be reported separately. Goodwill is not amortized, but it must be tested for impairment at least annually. If goodwill is impaired, it is written down to its new fair value and a loss recognized for the amount of the impairment. If the fair value of the consideration transferred by the acquirer in a business combination, along with the fair value of an equity interest already held, and the noncontrolling interest is less than the fair value of the acquiree's net identifiable assets, a situation referred to as a bargain purchase, the difference is recognized as a gain attributable to the acquirer.

All costs associated with a business combination are expensed as incurred. Any stock issue costs incurred in connection with a business combination are treated as a reduction in paid-in capital. A business combination is given effect as of the acquisition date for subsequent financial reporting.

Key Terms

acquisition method, *13*
bargain purchase, *19*
business combination, *6*
consolidated financial statements, *2*
control, *6*
differential, *16*
goodwill, *14*
liquidated, *10*
measurement period, *21*
minority interest, *12*
noncontrolling interest, *12*
parent company, *3*
parent–subsidiary relationship, *10*
pooling-of-interests method, *8*
primary beneficiary, *7*
special-purpose entity, *4*
spin-off, *6*
split-off, *6*
statutory consolidation, *10*
statutory merger, *10*
stock acquisition, *10*
subsidiary, *3*
tender offer, *11*

Questions

LO 1-1 **Q1-1** What types of circumstances would encourage management to establish a complex organizational structure?

LO 1-1 **Q1-2** How would the decision to dispose of a segment of operations using a split-off rather than a spin-off impact the financial statements of the company making the distribution?

LO 1-1 **Q1-3** Why did companies such as Enron find the use of special-purpose entities to be advantageous?

LO 1-4 **Q1-4** Describe each of the three legal forms that a business combination might take.

LO 1-1 **Q1-5** When does a noncontrolling interest arise in a business combination?

LO 1-5 **Q1-6** How is the amount reported as goodwill determined under the acquisition method?

LO 1-5 **Q1-7** What impact does the level of ownership have on the amount of goodwill reported under the acquisition method?

LO 1-5 **Q1-8** What is a differential?

LO 1-2, 1-5 **Q1-9** When a business combination occurs after the beginning of the year, the income earned by the acquired company between the beginning of the year and the date of combination is excluded from the net income reported by the combined entity for the year. Why?

LO 1-5 **Q1-10** What is the maximum balance in retained earnings that can be reported by the combined entity immediately following a business combination?

LO 1-5 **Q1-11** How is the amount of additional paid-in capital determined when recording a business combination?

LO 1-5 **Q1-12** Which of the costs incurred in completing a business combination are capitalized under the acquisition method?

LO 1-5 **Q1-13** Which of the costs incurred in completing a business combination should be treated as a reduction of additional paid-in capital?

LO 1-5 **Q1-14** When is goodwill considered impaired following a business combination?

LO 1-5 **Q1-15** When does a bargain purchase occur?

LO 1-6 **Q1-16** Within the measurement period following a business combination, the acquisition-date fair value of buildings acquired is determined to be less than initially recorded. How is the reduction in value recognized?

LO 1-6 **Q1-17** P Company reports its 10,000 shares of S Company at $40 per share. P Company then purchases an additional 60,000 shares of S Company for $65 each and gains control of S Company. What must be done with respect to the valuation of the shares previously owned?

Cases

LO 1-2, 1-5 **C1-1** **Assignment of Acquisition Costs**

Research

Troy Company notified Kline Company's shareholders that it was interested in purchasing controlling ownership of Kline and offered to exchange one share of Troy's common stock for each share of Kline Company submitted by July 31, 20X7. At the time of the offer, Troy's shares were trading for $35 per share and Kline's shares were trading at $28. Troy acquired all of the shares of Kline prior to December 31, 20X7, and transferred Kline's assets and liabilities to its books. In addition to issuing its shares, Troy paid a finder's fee of $200,000, stock registration and audit fees of $60,000, legal fees of $90,000 for transferring Kline's assets and liabilities to Troy, and $370,000 in legal fees to settle litigation brought by Kline's shareholders who alleged that the offering price was below the per-share fair value of Kline's net assets.

Required

Troy Company's vice president of finance has asked you to review the current accounting literature, including authoritative pronouncements, and prepare a memo reporting the required treatment of the additional costs at the time Kline Company was acquired. Support your recommendations with citations and quotations from the authoritative financial reporting standards or other literature.

LO 1-1, 1-3

C1-2 Evaluation of Merger

Research

One company may acquire another for a number of different reasons. The acquisition often has a significant impact on the financial statements. In 2005, 3M Corporation acquired CUNO Incorporated. Obtain a copy of the 3M 10-K filing for 2005. The 10-K reports the annual results for a company and is often available on the Investor Relations section of a company's website. It is also available on the SEC's website at www.SEC.gov.

Required

Use the 10-K for 2005 to find the answers to the following questions about 3M's acquisition of CUNO Inc. (*Hint:* You can search for the term CUNO once you have accessed the 10-K online.)

a. Provide at least one reason why 3M acquired CUNO.

b. How was the acquisition funded?

c. What was the impact of the CUNO acquisition on net accounts receivable?

d. What was the impact of the CUNO acquisition on inventories?

LO 1-4

C1-3 Business Combinations

Analysis

A merger boom comparable to those of the 1960s and mid-1980s occurred in the 1990s and into the new century. The merger activity of the 1960s was associated with increasing stock prices and heavy use of pooling-of-interests accounting. The mid-1980s activity was associated with a number of leveraged buyouts and acquisitions involving junk bonds. Merger activity in the early 1990s, on the other hand, appeared to involve primarily purchases with cash and standard debt instruments. By the mid-1990s, however, many business combinations were being effected through exchanges of stock. In the first decade of the new century, the nature of many business acquisitions changed, and by late 2008, the merger boom had slowed dramatically.

a. Which factors do you believe were the most prominent in encouraging business combinations in the 1990s? Which of these was the most important? Explain why.

b. Why were so many of the business combinations in the middle and late 1990s effected through exchanges of stock?

c. What factors had a heavy influence on mergers during the mid-2000s? How did many of the business combinations of this period differ from earlier combinations? Why did the merger boom slow so dramatically late in 2008 and in 2009?

d. If a major review of the tax laws were undertaken, would it be wise or unwise public policy to establish greater tax incentives for corporate mergers? Propose three incentives that might be used.

e. If the FASB were interested in encouraging more mergers, what action should it take with regard to revising or eliminating existing accounting standards? Explain.

LO 1-5

C1-4 Determination of Goodwill Impairment

Research

Plush Corporation purchased 100 percent of Common Corporation's common stock on January 1, 20X3, and paid $450,000. The fair value of Common's identifiable net assets at that date was $430,000. By the end of 20X5, the fair value of Common, which Plush considers to be a reporting unit, had increased to $485,000; however, Plush's external auditor made a passing comment to the company's chief accountant that Plush might need to recognize impairment of goodwill on one or more of its investments.

Required

Prepare a memo to Plush's chief accountant indicating the tests used in determining whether goodwill has been impaired. Include in your discussion one or more possible conditions under which Plush might be required to recognize impairment of goodwill on its investment in Common Corporation. In preparing your memo, review the current accounting literature, including authoritative pronouncements of the FASB and other appropriate bodies. Support your discussion with citations and quotations from the applicable literature.

LO 1-1

C1-5 Risks Associated with Acquisitions

Analysis

Not all business combinations are successful, and many entail substantial risk. Acquiring another company may involve a number of different types of risk. Obtain a copy of the 10-K report for Google, Inc., for the year ended December 31, 2006, available at the SEC's website (www.sec.gov). The report also can be accessed through Yahoo! Finance or the company's Investor Relations page.

Required

On page 21 of the 10-K report, Google provides information to investors about its motivation for acquiring companies and the possible risks associated with such acquisitions. Briefly discuss the risks that Google sees inherent in potential acquisitions.

LO 1-1

C1-6 Numbers Game

Communication

Arthur Levitt's speech, "The Numbers Game," is available on the SEC's website at www.sec.gov/news/speech/speecharchive/1998/spch220.txt. Read the speech, and then answer the following questions.

Required

a. Briefly explain what motivations Levitt discusses for earnings management.
b. What specific techniques for earnings management does Levitt discuss?
c. According to Levitt, why is the issue of earnings management important?

LO 1-1, 1-4

C1-7 MCI: A Succession of Mergers

Research

MCI WorldCom, Inc. (later MCI), was known as a high-flying company, having had its roots in a small local company and rising to one of the world's largest communications giants. The company's spectacular growth was accomplished through a string of business combinations. However, not all went as planned, and MCI is no longer an independent company.

Required

Provide a brief history of, and indicate subsequent events related to, MCI WorldCom. Include in your discussion the following:

a. Trace the major acquisitions leading to MCI WorldCom and indicate the type of consideration used in the acquisitions.
b. Who is Bernard Ebbers, and where is he now?
c. What happened to MCI WorldCom, and where is it now?

LO 1-4

C1-8 Leveraged Buyouts

Analysis

A type of acquisition that was not discussed in the chapter is the *leveraged buyout.* Many experts argue that a leveraged buyout (LBO) is not a type of business combination but rather just a restructuring of ownership. Yet some would see an LBO as having many of the characteristics of a business combination. The number of LBOs in recent years has grown dramatically and, therefore, accounting for these transactions is of increased importance.

Required

a. What is a leveraged buyout? How does an LBO compare with a management buyout (MBO)?
b. What authoritative pronouncements, if any, deal with leveraged buyouts?
c. Is a leveraged buyout a type of business combination? Explain.
d. What is the major issue in determining the proper basis for an interest in a company purchased through a leveraged buyout?

Exercises

LO 1-1, 1-3, 1-5

E1-1 Multiple-Choice Questions on Complex Organizations

Select the correct answer for each of the following questions.

1. Growth in the complexity of the U.S. business environment
   a. Has led to increased use of partnerships to avoid legal liability.
   b. Has led to increasingly complex organizational structures as management has attempted to achieve its business objectives.
   c. Has encouraged companies to reduce the number of operating divisions and product lines so they may better control those they retain.
   d. Has had no particular impact on the organizational structures or the way in which companies are managed.
2. Which of the following is *not* an appropriate reason for establishing a subsidiary?
   a. The parent wishes to protect existing operations by shifting new activities with greater risk to a newly created subsidiary.
   b. The parent wishes to avoid subjecting all of its operations to regulatory control by establishing a subsidiary that focuses its operations in regulated industries.
   c. The parent wishes to reduce its taxes by establishing a subsidiary that focuses its operations in areas where special tax benefits are available.
   d. The parent wishes to be able to increase its reported sales by transferring products to the subsidiary at the end of the fiscal year.
3. Which of the following actions is likely to result in recording goodwill on Randolph Company's books?
   a. Randolph acquires Penn Corporation in a business combination recorded as a merger.
   b. Randolph acquires a majority of Penn's common stock in a business combination and continues to operate it as a subsidiary.
   c. Randolph distributes ownership of a newly created subsidiary in a distribution considered to be a spin-off.
   d. Randolph distributes ownership of a newly created subsidiary in a distribution considered to be a split-off.
4. When an existing company creates a new subsidiary and transfers a portion of its assets and liabilities to the new entity
   a. The new entity records both the assets and liabilities it received at fair values.
   b. The new entity records both the assets and liabilities it received at the carrying values of the original company.
   c. The original company records a gain or loss on the difference between its carrying values and the fair values of the assets transferred to the new entity.
   d. The original company records the difference between the carrying values and the fair values of the assets transferred to the new entity as goodwill.
5. When a company assigns goodwill to a reporting unit acquired in a business combination, it must record an impairment loss if
   a. The fair value of the net identifiable assets held by a reporting unit decreases.
   b. The fair value of the reporting unit decreases.
   c. The carrying value of the reporting unit is less than the fair value of the reporting unit.
   d. The fair value of the reporting unit is less than its carrying value and the carrying value of goodwill is more than the implied value of its goodwill.

LO 1-2, 1-5

E1-2 Multiple-Choice Questions on Recording Business Combinations [AICPA Adapted]

Select the correct answer for each of the following questions.

1. Goodwill represents the excess of the sum of the fair value of the (1) consideration given, (2) shares already owned, and (3) the noncontrolling interest over the
   a. Sum of the fair values assigned to identifiable assets acquired less liabilities assumed.
   b. Sum of the fair values assigned to tangible assets acquired less liabilities assumed.
   c. Sum of the fair values assigned to intangible assets acquired less liabilities assumed.
   d. Book value of an acquired company.

2. In a business combination, costs of registering equity securities to be issued by the acquiring company are a(n)

   a. Expense of the combined company for the period in which the costs were incurred.
   b. Direct addition to stockholders' equity of the combined company.
   c. Reduction of the recorded value of the securities.
   d. Addition to goodwill.

3. Which of the following is the appropriate basis for valuing fixed assets acquired in a business combination carried out by exchanging cash for common stock?

   a. Historical cost.
   b. Book value.
   c. Cost plus any excess of purchase price over book value of assets acquired.
   d. Fair value.

4. In a business combination in which an acquiring company purchases 100 percent of the outstanding common stock of another company, if the fair value of the net identifiable assets acquired exceeds the fair value of the consideration given. The excess should be reported as a

   a. Deferred credit.
   b. Reduction of the values assigned to current assets and a deferred credit for any unallocated portion.
   c. Pro rata reduction of the values assigned to current and noncurrent assets and a deferred credit for any unallocated portion.
   d. No answer listed is correct.

5. A and B Companies have been operating separately for five years. Each company has a minimal amount of liabilities and a simple capital structure consisting solely of voting common stock. In exchange for 40 percent of its voting stock A Company, acquires 80 percent of the common stock of B Company. This is a "tax-free" stock-for-stock exchange for tax purposes. B Company's identifiable assets have a total net fair market value of $800,000 and a total net book value of $580,000. The fair market value of the A stock used in the exchange is $700,000, and the fair value of the noncontrolling interest is $175,000. The goodwill reported following the acquisition would be

   a. Zero.
   b. $60,000.
   c. $75,000.
   d. $295,000.

LO 1-2, 1-5

E1-3 Multiple-Choice Questions on Reported Balances [AICPA Adapted]

Select the correct answer for each of the following questions.

1. On December 31, 20X3, Saxe Corporation was merged into Poe Corporation. In the business combination, Poe issued 200,000 shares of its $10 par common stock, with a market price of $18 a share, for all of Saxe's common stock. The stockholders' equity section of each company's balance sheet immediately before the combination was:

	Poe	Saxe
Common Stock	$3,000,000	$1,500,000
Additional Paid-In Capital	1,300,000	150,000
Retained Earnings	2,500,000	850,000
	$6,800,000	$2,500,000

In the December 31, 20X3, consolidated balance sheet, additional paid-in capital should be reported at

a. $950,000.
b. $1,300,000.
c. $1,450,000.
d. $2,900,000.

2. On January 1, 20X1, Rolan Corporation issued 10,000 shares of common stock in exchange for all of Sandin Corporation's outstanding stock. Condensed balance sheets of Rolan and Sandin immediately before the combination follow:

	Rolan	**Sandin**
Total Assets	$1,000,000	$500,000
Liabilities	$ 300,000	$150,000
Common Stock ($10 par)	200,000	100,000
Retained Earnings	500,000	250,000
Total Liabilities & Equities	$1,000,000	$500,000

Rolan's common stock had a market price of $60 per share on January 1, 20X1. The market price of Sandin's stock was not readily determinable. The fair value of Sandin's net identifiable assets was determined to be $570,000. Rolan's investment in Sandin's stock will be stated in Rolan's balance sheet immediately after the combination in the amount of

a. $350,000.
b. $500,000.
c. $570,000.
d. $600,000.

3. On April 1, 20X2, Jack Company paid $800,000 for all of Ann Corporation's issued and outstanding common stock. Ann's recorded assets and liabilities on April 1, 20X2, were as follows:

Cash	$ 80,000
Inventory	240,000
Property & equipment (net of accumulated depreciation of $320,000)	480,000
Liabilities	(180,000)

On April 1, 20X2, Ann's inventory was determined to have a fair value of $190,000, and the property and equipment had a fair value of $560,000. What is the amount of goodwill resulting from the business combination?

a. $0.
b. $50,000.
c. $150,000.
d. $180,000.

4. Action Corporation issued nonvoting preferred stock with a fair market value of $4,000,000 in exchange for all the outstanding common stock of Master Corporation. On the date of the exchange, Master had tangible net assets with a book value of $2,000,000 and a fair value of $2,500,000. In addition, Action issued preferred stock valued at $400,000 to an individual as a finder's fee in arranging the transaction. As a result of this transaction, Action should record an increase in net assets of

a. $2,000,000.
b. $2,500,000.
c. $4,000,000.
d. $4,400,000.

LO 1-2, 1-5

E1-4 Multiple-Choice Questions Involving Account Balances

Select the correct answer for each of the following questions.

1. Topper Company established a subsidiary and transferred equipment with a fair value of $72,000 to the subsidiary. Topper had purchased the equipment with ten-year expected life of four years earlier for $100,000 and has used straight-line depreciation with no expected residual value. At the time of the transfer, the subsidiary should record
   a. Equipment at $72,000 and no accumulated depreciation.
   b. Equipment at $60,000 and no accumulated depreciation.
   c. Equipment at $100,000 and accumulated depreciation of $40,000.
   d. Equipment at $120,000 and accumulated depreciation of $48,000.
2. Lead Corporation established a new subsidiary and transferred to it assets with a cost of $90,000 and a book value of $75,000. The assets had a fair value of $100,000 at the time of transfer. The transfer will result in
   a. A reduction of net assets reported by Lead Corporation of $90,000.
   b. A reduction of net assets reported by Lead Corporation of $75,000.
   c. No change in the reported net assets of Lead Corporation.
   d. An increase in the net assets reported by Lead Corporation of $25,000.
3. Tear Company, a newly established subsidiary of Stern Corporation, received assets with an original cost of $260,000, a fair value of $200,000, and a book value of $140,000 from the parent in exchange for 7,000 shares of Tear's $8 par value common stock. Tear should record
   a. Additional paid-in capital of $0.
   b. Additional paid-in capital of $84,000.
   c. Additional paid-in capital of $144,000.
   d. Additional paid-in capital of $204,000.
4. Grout Company reports assets with a carrying value of $420,000 (including goodwill with a carrying value of $35,000) assigned to an identifiable reporting unit purchased at the end of the prior year. The fair value of the net assets held by the reporting unit is currently $350,000, and the fair value of the reporting unit is $395,000. At the end of the current period, Grout should report goodwill of
   a. $45,000.
   b. $35,000.
   c. $25,000.
   d. $10,000.
5. Twill Company has a reporting unit with the fair value of its net identifiable assets of $500,000. The carrying value of the reporting unit's net assets on Twill's books is $575,000, which includes $90,000 of goodwill. The fair value of the reporting unit is $560,000. Twill should report impairment of goodwill of
   a. $60,000.
   b. $30,000.
   c. $15,000.
   d. $0.

LO 1-3

E1-5 Asset Transfer to Subsidiary

Pale Company was established on January 1, 20X1. Along with other assets, it immediately purchased land for $80,000, a building for $240,000, and equipment for $90,000. On January 1, 20X5, Pale transferred these assets, cash of $21,000, and inventory costing $37,000 to a newly created subsidiary, Bright Company, in exchange for 10,000 shares of Bright's $6 par value stock. Pale uses straight-line depreciation and useful lives of 40 years and 10 years for the building and equipment, respectively, with no estimated residual values.

Required

a. Give the journal entry that Pale recorded when it transferred the assets to Bright.
b. Give the journal entry that Bright recorded for the receipt of assets and issuance of common stock to Pale.

LO 1-3

E1-6 Creation of New Subsidiary

Lester Company transferred the following assets to a newly created subsidiary, Mumby Corporation, in exchange for 40,000 shares of its $3 par value stock:

	Cost	Book Value
Cash	$ 40,000	$ 40,000
Accounts Receivable	75,000	68,000
Inventory	50,000	50,000
Land	35,000	35,000
Buildings	160,000	125,000
Equipment	240,000	180,000

Required

a. Give the journal entry in which Lester recorded the transfer of assets to Mumby Corporation.

b. Give the journal entry in which Mumby recorded the receipt of assets and issuance of common stock to Lester.

LO 1-2, 1-3

E1-7 Balance Sheet Totals of Parent Company

Foster Corporation established Kline Company as a wholly owned subsidiary. Foster reported the following balance sheet amounts immediately before and after it transferred assets and accounts payable to Kline Company in exchange for 4,000 shares of $12 par value common stock:

	Amount Reported			
	Before Transfer		After Transfer	
Cash		$ 40,000		$ 25,000
Accounts Receivable		65,000		41,000
Inventory		30,000		21,000
Investment in Kline Company				66,000
Land		15,000		12,000
Depreciable Assets	$180,000		$115,000	
Accumulated Depreciation	75,000	105,000	47,000	68,000
Total Assets		$255,000		$233,000
Accounts Payable		$ 40,000		$ 18,000
Bonds Payable		80,000		80,000
Common Stock		60,000		60,000
Retained Earnings		75,000		75,000
Total Liabilities and Equities		$255,000		$233,000

Required

a. Give the journal entry that Foster recorded when it transferred its assets and accounts payable to Kline.

b. Give the journal entry that Kline recorded upon receipt of the assets and accounts payable from Foster.

LO 1-2, 1-5

E1-8 Acquisition of Net Assets

Sun Corporation concluded the fair value of Tender Company was $60,000 and paid that amount to acquire its net assets. Tender reported assets with a book value of $55,000 and fair value of $71,000 and liabilities with a book value and fair value of $20,000 on the date of combination. Sun also paid $4,000 to a search firm for finder's fees related to the acquisition.

Required

Give the journal entries to be made by Sun to record its investment in Tender and its payment of the finder's fees.

LO 1-5

E1-9 Reporting Goodwill

Samper Company reported the book value of its net assets at $160,000 when Public Corporation acquired 100 percent of its voting stock for cash. The fair value of Samper's net assets was determined to be $190,000 on that date.

Required

Determine the amount of goodwill to be reported in consolidated financial statements presented immediately following the combination and the amount at which Public will record its investment in Samper if the amount paid by Public is

a. $310,000.
b. $196,000.
c. $150,000.

LO 1-5

E1-10 Stock Acquisition

McDermott Corporation has been in the midst of a major expansion program. Much of its growth had been internal, but in 20X1 McDermott decided to continue its expansion through the acquisition of other companies. The first company acquired was Tippy Inc., a small manufacturer of inertial guidance systems for aircraft and missiles. On June 10, 20X1, McDermott issued 17,000 shares of its $25 par common stock for all 40,000 of Tippy's $10 par common shares. At the date of combination, Tippy reported additional paid-in capital of $100,000 and retained earnings of $350,000. McDermott's stock was selling for $58 per share immediately prior to the combination. Subsequent to the combination, Tippy operated as a subsidiary of McDermott.

Required

Present the journal entry or entries that McDermott would make to record the business combination with Tippy.

LO 1-5

E1-11 Balances Reported Following Combination

Elm Corporation and Maple Company have announced terms of an exchange agreement under which Elm will issue 8,000 shares of its $10 par value common stock to acquire all of Maple Company's assets. Elm shares currently are trading at $50, and Maple $5 par value shares are trading at $18 each. Historical cost and fair value balance sheet data on January 1, 20X2, are as follows:

	Elm Corporation		Maple Company	
Balance Sheet Item	**Book Value**	**Fair Value**	**Book Value**	**Fair Value**
Cash & Receivables	$150,000	$150,000	$ 40,000	$ 40,000
Land	100,000	170,000	50,000	85,000
Buildings & Equipment (net)	300,000	400,000	160,000	230,000
Total Assets	$550,000	$720,000	$250,000	$355,000
Common Stock	$200,000		$100,000	
Additional Paid-In Capital	20,000		10,000	
Retained Earnings	330,000		140,000	
Total Equities	$550,000		$250,000	

Required

What amount will be reported immediately following the business combination for each of the following items in the combined company's balance sheet?

a. Common Stock.
b. Cash and Receivables.
c. Land.
d. Buildings and Equipment (net).

e. Goodwill.
f. Additional Paid-In Capital.
g. Retained Earnings.

LO 1-5

E1-12 Goodwill Recognition

Spur Corporation reported the following balance sheet amounts on December 31, 20X1:

Balance Sheet Item	Historical Cost	Fair Value
Cash & Receivables	$ 50,000	$ 40,000
Inventory	100,000	150,000
Land	40,000	30,000
Plant & Equipment	400,000	350,000
Less: Accumulated Depreciation	(150,000)	
Patent		130,000
Total Assets	$440,000	$700,000
Accounts Payable	$ 80,000	$ 85,000
Common Stock	200,000	
Additional Paid-In Capital	20,000	
Retained Earnings	140,000	
Total Liabilities & Equities	$440,000	

Required

Blanket acquired Spur Corporation's assets and liabilities for $670,000 cash on December 31, 20X1. Give the entry that Blanket made to record the purchase.

LO 1-5

E1-13 Acquisition Using Debentures

Fortune Corporation used debentures with a par value of $625,000 to acquire 100 percent of Sorden Company's net assets on January 1, 20X2. On that date, the fair value of the bonds issued by Fortune was $608,000. The following balance sheet data were reported by Sorden:

Balance Sheet Item	Historical Cost	Fair Value
Cash & Receivables	$ 55,000	$ 50,000
Inventory	105,000	200,000
Land	60,000	100,000
Plant & Equipment	400,000	300,000
Less: Accumulated Depreciation	(150,000)	
Goodwill	10,000	
Total Assets	$480,000	$650,000
Accounts Payable	$ 50,000	$ 50,000
Common Stock	100,000	
Additional Paid-In Capital	60,000	
Retained Earnings	270,000	
Total Liabilities & Equities	$480,000	

Required

Give the journal entry that Fortune recorded at the time of exchange.

LO 1-5

E1-14 Bargain Purchase

Using the data presented in E1-13, determine the amount Fortune Corporation would record as a gain on bargain purchase and prepare the journal entry Fortune would record at the time of the exchange if Fortune issued bonds with a par value of $580,000 and a fair value of $564,000 in completing the acquisition of Sorden.

LO 1-5

E1-15 Impairment of Goodwill

Mesa Corporation purchased Kwick Company's net assets and assigned goodwill of $80,000 to Reporting Division K. The following assets and liabilities are assigned to Reporting Division K:

	Carrying Amount	Fair Value
Cash	$ 14,000	$ 14,000
Inventory	56,000	71,000
Equipment	170,000	190,000
Goodwill	80,000	
Accounts Payable	30,000	30,000

Required

Determine the amount of goodwill to be reported for Division K and the amount of goodwill impairment to be recognized, if any, if Division K's fair value is determined to be

a. $340,000.
b. $280,000.
c. $260,000.

LO 1-5

E1-16 Assignment of Goodwill

Double Corporation acquired all of the common stock of Simple Company for $450,000 on January 1, 20X4. On that date, Simple's identifiable net assets had a fair value of $390,000. The assets acquired in the purchase of Simple are considered to be a separate reporting unit of Double. The carrying value of Double's investment at December 31, 20X4, is $500,000.

Required

Determine the amount of goodwill impairment, if any, that should be recognized at December 31, 20X4, if the fair value of the net assets (excluding goodwill) at that date is $440,000 and the fair value of the reporting unit is determined to be

a. $530,000.
b. $485,000.
c. $450,000.

LO 1-5

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E1-17 Goodwill Assigned to Reporting Units

Groft Company purchased Strobe Company's net assets and assigned them to four separate reporting units. Total goodwill of $186,000 is assigned to the reporting units as indicated:

	Reporting Unit			
	A	B	C	D
Carrying value of investment	$700,000	$330,000	$380,000	$520,000
Goodwill included in carrying value	60,000	48,000	28,000	50,000
Fair value of net identifiable assets at year-end	600,000	300,000	400,000	500,000
Fair value of reporting unit at year-end	690,000	335,000	370,000	585,000

Required

Determine the amount of goodwill that Groft should report at year-end. Show how you computed it.

LO 1-5

E1-18 Goodwill Measurement

Washer Company has a reporting unit resulting from an earlier business combination. The reporting unit's current assets and liabilities are

	Carrying Amount	Fair Value
Cash	$ 30,000	$ 30,000
Inventory	70,000	100,000
Land	30,000	60,000
Buildings	210,000	230,000
Equipment	160,000	170,000
Goodwill	150,000	
Notes Payable	100,000	100,000

Required

Determine the amount of goodwill to be reported and the amount of goodwill impairment, if any, if the fair value of the reporting unit is determined to be

a. $580,000.

b. $540,000.

c. $500,000.

d. $460,000.

LO 1-5

E1-19 Computation of Fair Value

Grant Company acquired all of Bedford Corporation's assets and liabilities on January 1, 20X2, in a business combination. At that date, Bedford reported assets with a book value of $624,000 and liabilities of $356,000. Grant noted that Bedford had $40,000 of capitalized research and development costs on its books at the acquisition date that did not appear to be of value. Grant also determined that patents developed by Bedford had a fair value of $120,000 but had not been recorded by Bedford. Except for buildings and equipment, Grant determined the fair value of all other assets and liabilities reported by Bedford approximated the recorded amounts. In recording the transfer of assets and liabilities to its books, Grant recorded goodwill of $93,000. Grant paid $517,000 to acquire Bedford's assets and liabilities. If the book value of Bedford's buildings and equipment was $341,000 at the date of acquisition, what was their fair value?

LO 1-5

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E1-20 Computation of Shares Issued and Goodwill

Dunyain Company acquired Allsap Corporation on January 1, 20X1, through an exchange of common shares. All of Allsap's assets and liabilities were immediately transferred to Dunyain, which reported total par value of shares outstanding of $218,400 and $327,600 and additional paid-in capital of $370,000 and $650,800 immediately before and after the business combination, respectively.

Required

a. Assuming that Dunyain's common stock had a market value of $25 per share at the time of exchange, what number of shares was issued?

b. What is the par value per share of Dunyain's common stock?

c. Assuming that Allsap's identifiable assets had a fair value of $476,000 and its liabilities had a fair value of $120,000, what amount of goodwill did Dunyain record at the time of the business combination?

LO 1-5

E1-21 Combined Balance Sheet

The following balance sheets were prepared for Adam Corporation and Best Company on January 1, 20X2, just before they entered into a business combination:

	Adam Corporation		Best Company	
Item	**Book Value**	**Fair Value**	**Book Value**	**Fair Value**
Cash & Receivables	$150,000	$150,000	$ 90,000	$ 90,000
Inventory	300,000	380,000	70,000	160,000
Buildings & Equipment	600,000	430,000	250,000	240,000
Less: Accumulated Depreciation	(250,000)		(80,000)	
Total Assets	$800,000	$960,000	$330,000	$490,000
Accounts Payable	$ 75,000	$ 75,000	$ 50,000	$ 50,000
Notes Payable	200,000	215,000	30,000	35,000
Common Stock:				
$8 par value	180,000			
$6 par value			90,000	
Additional Paid-In Capital	140,000		55,000	
Retained Earnings	205,000		105,000	
Total Liabilities & Equities	$800,000		$330,000	

Adam acquired all of Best Company's assets and liabilities on January 1, 20X2, in exchange for its common shares. Adam issued 8,000 shares of stock to complete the business combination.

Required

Prepare a balance sheet of the combined company immediately following the acquisition, assuming Adam's shares were trading at $60 each.

LO 1-5

E1-22 Recording a Business Combination

The following financial statement information was prepared for Blue Corporation and Sparse Company at December 31, 20X2:

Balance Sheets
December 31, 20X2

	Blue Corporation		Sparse Company	
Cash		$ 140,000		$ 70,000
Accounts Receivable		170,000		110,000
Inventory		250,000		180,000
Land		80,000		100,000
Buildings & Equipment	$ 680,000		$ 450,000	
Less: Accumulated Depreciation	(320,000)	360,000	(230,000)	220,000
Goodwill		70,000		20,000
Total Assets		$1,070,000		$700,000
Accounts Payable		$ 70,000		$195,000
Bonds Payable		320,000		100,000
Bond Premium				10,000
Common Stock		120,000		150,000
Additional Paid-In Capital		170,000		60,000
Retained Earnings		390,000		185,000
Total Liabilities & Equities		$1,070,000		$700,000

Blue and Sparse agreed to combine as of January 1, 20X3. To effect the merger, Blue paid finder's fees of $30,000 and legal fees of $24,000. Blue also paid $15,000 of audit fees related to the issuance of stock, stock registration fees of $8,000, and stock listing application fees of $6,000.

At January 1, 20X3, book values of Sparse Company's assets and liabilities approximated market value except for inventory with a market value of $200,000, buildings and equipment with a market value of $350,000, and bonds payable with a market value of $105,000. All assets and liabilities were immediately recorded on Blue's books.

Required

Give all journal entries that Blue recorded assuming Blue issued 40,000 shares of $8 par value common stock to acquire all of Sparse's assets and liabilities in a business combination. Blue common stock was trading at $14 per share on January 1, 20X3.

LO 1-5

E1-23 Reporting Income

On July 1, 20X2, Alan Enterprises merged with Cherry Corporation through an exchange of stock and the subsequent liquidation of Cherry. Alan issued 200,000 shares of its stock to effect the combination. The book values of Cherry's assets and liabilities were equal to their fair values at the date of combination, and the value of the shares exchanged was equal to Cherry's book value. Information relating to income for the companies is as follows:

	20X1	Jan. 1–June 30, 20X2	July 1–Dec. 31, 20X2
Net Income:			
Alan Enterprises	$4,460,000	$2,500,000	$3,528,000
Cherry Corporation	1,300,000	692,000	—

Alan Enterprises had 1,000,000 shares of stock outstanding prior to the combination. Remember that when calculating earnings per share (EPS) for the year of the combination, the shares issued in the combination were not outstanding for the entire year.

Required

Compute the net income and earnings-per-share amounts that would be reported in Alan's 20X2 comparative income statements for both 20X2 and 20X1.

Problems

LO 1-3

P1-24 Assets and Accounts Payable Transferred to Subsidiary

Tab Corporation decided to establish Collon Company as a wholly owned subsidiary by transferring some of its existing assets and liabilities to the new entity. In exchange, Collon issued Tab 30,000 shares of $6 par value common stock. The following information is provided on the assets and accounts payable transferred:

	Cost	Book Value	Fair Value
Cash	$ 25,000	$ 25,000	$ 25,000
Inventory	70,000	70,000	70,000
Land	60,000	60,000	90,000
Buildings	170,000	130,000	240,000
Equipment	90,000	80,000	105,000
Accounts Payable	45,000	45,000	45,000

Required

a. Give the journal entry that Tab recorded for the transfer of assets and accounts payable to Collon.

b. Give the journal entry that Collon recorded for the receipt of assets and accounts payable from Tab.

LO 1-3

P1-25 Creation of New Subsidiary

Eagle Corporation established a subsidiary to enter into a new line of business considered to be substantially more risky than Eagle's current business. Eagle transferred the following assets and accounts payable to Sand Corporation in exchange for 5,000 shares of $10 par value stock of Sand:

	Cost	Book Value
Cash	$ 30,000	$ 30,000
Accounts Receivable	45,000	40,000
Inventory	60,000	60,000
Land	20,000	20,000
Buildings & Equipment	300,000	260,000
Accounts Payable	10,000	10,000

Required

a. Give the journal entry that Eagle recorded for the transfer of assets and accounts payable to Sand.

b. Give the journal entry that Sand recorded for receipt of the assets and accounts payable from Eagle.

LO 1-3

P1-26 Incomplete Data on Creation of Subsidiary

Thumb Company created New Company as a wholly owned subsidiary by transferring assets and accounts payable to New in exchange for its common stock. New recorded the following entry when it received the assets and accounts payable:

Cash	3,000	
Accounts Receivable	16,000	
Inventory	27,000	
Land	9,000	
Buildings	70,000	
Equipment	60,000	
Accounts Payable		14,000
Accumulated Depreciation—Buildings		21,000
Accumulated Depreciation—Equipment		12,000
Common Stock		40,000
Additional Paid-In Capital		98,000

Required

a. What was Thumb's book value of the total assets (not net assets) transferred to New Company?

b. What amount did Thumb report as its investment in New after the transfer?

c. What number of shares of $5 par value stock did New issue to Thumb?

d. What impact did the transfer of assets and accounts payable have on the amount reported by Thumb as total assets?

e. What impact did the transfer of assets and accounts payable have on the amount that Thumb and the consolidated entity reported as shares outstanding?

LO 1-5

P1-27 Acquisition in Multiple Steps

Deal Corporation issued 4,000 shares of its $10 par value stock with a market value of $85,000 to acquire 85 percent ownership of Mead Company on August 31, 20X3. Mead's fair value was determined to be $100,000 on that date. Deal had earlier purchased 15 percent of Mead's shares for $9,000 and used the cost method in accounting for its investment in Mead. Deal later paid appraisal fees of $3,500 and stock issue costs of $2,000 incurred in completing the acquisition of the additional shares.

Required

Give the journal entries to be recorded by Deal in completing the acquisition of the additional shares of Mead.

LO 1-5

P1-28 Journal Entries to Record a Business Combination

On January 1, 20X2, Frost Company acquired all of TKK Corporation's assets and liabilities by issuing 24,000 shares of its $4 par value common stock. At that date, Frost shares were

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selling at $22 per share. Historical cost and fair value balance sheet data for TKK at the time of acquisition were as follows:

Balance Sheet Item	Historical Cost	Fair Value
Cash & Receivables	$ 28,000	$ 28,000
Inventory	94,000	122,000
Buildings & Equipment	600,000	470,000
Less: Accumulated Depreciation	(240,000)	
Total Assets	$ 482,000	$620,000
Accounts Payable	$ 41,000	$ 41,000
Notes Payable	65,000	63,000
Common Stock ($10 par value)	160,000	
Retained Earnings	216,000	
Total Liabilities & Equities	$ 482,000	

Frost paid legal fees for the transfer of assets and liabilities of $14,000. Frost also paid audit fees of $21,000 and listing application fees of $7,000, both related to the issuance of new shares.

Required

Prepare the journal entries made by Frost to record the business combination.

LO 1-5

P1-29 Recording Business Combinations

Flint Corporation exchanged shares of its $2 par common stock for all of Mark Company's assets and liabilities in a planned merger. Immediately prior to the combination, Mark's assets and liabilities were as follows:

Assets	
Cash & Equivalents	$ 41,000
Accounts Receivable	73,000
Inventory	144,000
Land	200,000
Buildings	1,520,000
Equipment	638,000
Accumulated Depreciation	(431,000)
Total Assets	$2,185,000

Liabilities and Equities	
Accounts Payable	$ 35,000
Short-Term Notes Payable	50,000
Bonds Payable	500,000
Common Stock ($10 par)	1,000,000
Additional Paid-In Capital	325,000
Retained Earnings	275,000
Total Liabilities & Equities	$2,185,000

Immediately prior to the combination, Flint reported $250,000 additional paid-in capital and $1,350,000 retained earnings. The fair values of Mark's assets and liabilities were equal to their book values on the date of combination except that Mark's buildings were worth $1,500,000 and its equipment was worth $300,000. Costs associated with planning and completing the business combination totaled $38,000, and stock issue costs totaled $22,000. The market value of Flint's stock at the date of combination was $4 per share.

Required

Prepare the journal entries that would appear on Flint's books to record the combination if Flint issued 450,000 shares.

LO 1-5

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P1-30 Business Combination with Goodwill

Anchor Corporation paid cash of $178,000 to acquire Zink Company's net assets on February 1, 20X3. The balance sheet data for the two companies and fair value information for Zink immediately before the business combination were:

	Anchor Corporation	Zink Company	
Balance Sheet Item	**Book Value**	**Book Value**	**Fair Value**
Cash	$ 240,000	$ 20,000	$ 20,000
Accounts Receivable	140,000	35,000	35,000
Inventory	170,000	30,000	50,000
Patents	80,000	40,000	60,000
Buildings & Equipment	380,000	310,000	150,000
Less: Accumulated Depreciation	(190,000)	(200,000)	
Total Assets	$ 820,000	$ 235,000	$315,000
Accounts Payable	$ 85,000	$ 55,000	$ 55,000
Notes Payable	150,000	120,000	120,000
Common Stock:			
$10 par value	200,000		
$6 par value		18,000	
Additional Paid-In Capital	160,000	10,000	
Retained Earnings	225,000	32,000	
Total Liabilities & Equities	$ 820,000	$ 235,000	

Required

a. Give the journal entry recorded by Anchor Corporation when it acquired Zink's net assets.

b. Prepare a balance sheet for Anchor immediately following the acquisition.

c. Give the journal entry to be recorded by Anchor if it acquires all of Zink's common stock (instead of Zink's net assets) for $178,000.

LO 1-5

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P1-31 Bargain Purchase

Bower Company purchased Lark Corporation's net assets on January 3, 20X2, for $625,000 cash. In addition, Bower incurred $5,000 of direct costs in consummating the combination. At the time of acquisition, Lark reported the following historical cost and current market data:

Balance Sheet Item	Book Value	Fair Value
Cash & Receivables	$ 50,000	$ 50,000
Inventory	100,000	150,000
Buildings & Equipment (net)	200,000	300,000
Patent	—	200,000
Total Assets	$350,000	$700,000
Accounts Payable	$ 30,000	$ 30,000
Common Stock	100,000	
Additional Paid-In Capital	80,000	
Retained Earnings	140,000	
Total Liabilities & Equities	$350,000	

Required

Give the journal entry or entries with which Bower recorded its acquisition of Lark's net assets.

LO 1-5

P1-32 Computation of Account Balances

Aspro Division is considered to be an individual reporting unit of Tabor Company. Tabor acquired the division by issuing 100,000 shares of its common stock with a market price of $7.60 each. Tabor management was able to identify assets with fair values of $810,000 and liabilities of $190,000 at the date of acquisition. At the end of the first year, the reporting unit had assets with a fair value of $950,000, and the fair value of the reporting entity was $930,000. Tabor's accountants concluded it must recognize impairment of goodwill in the amount of $30,000 at the end of the first year.

Required

a. Determine the fair value of the reporting unit's liabilities at the end of the first year. Show your computation.

b. If the reporting unit's liabilities at the end of the period had been $70,000, what would the fair value of the reporting unit have to have been to avoid recognizing an impairment of goodwill? Show your computation.

LO 1-5

P1-33 Goodwill Assigned to Multiple Reporting Units

The fair values of assets and liabilities held by three reporting units and other information related to the reporting units owned by Rover Company are as follows:

	Reporting Unit		
	A	B	C
Cash & Receivables	$ 30,000	$ 80,000	$ 20,000
Inventory	60,000	100,000	40,000
Land	20,000	30,000	10,000
Buildings	100,000	150,000	80,000
Equipment	140,000	90,000	50,000
Accounts Payable	40,000	60,000	10,000
Fair Value of Reporting Unit	400,000	440,000	265,000
Carrying Value of Investment	420,000	500,000	290,000
Goodwill Included in Carrying Value	70,000	80,000	40,000

Required

a. Determine the amount of goodwill that Rover should report in its current financial statements.

b. Determine the amount, if any, that Rover should report as impairment of goodwill for the current period.

LO 1-5

P1-34 Journal Entries

On January 1, 20X3, PURE Products Corporation issued 12,000 shares of its $10 par value stock to acquire the net assets of Light Steel Company. Underlying book value and fair value information for the balance sheet items of Light Steel at the time of acquisition follow:

Balance Sheet Item	Book Value	Fair Value
Cash	$ 60,000	$ 60,000
Accounts Receivable	100,000	100,000
Inventory (LIFO basis)	60,000	115,000
Land	50,000	70,000
Buildings & Equipment	400,000	350,000
Less: Accumulated Depreciation	(150,000)	—
Total Assets	$ 520,000	$695,000
Accounts Payable	$ 10,000	$ 10,000
Bonds Payable	200,000	180,000
Common Stock ($5 par value)	150,000	
Additional Paid-In Capital	70,000	
Retained Earnings	90,000	
Total Liabilities & Equities	$ 520,000	

Light Steel shares were selling at $18 and PURE Products shares were selling at $50 just before the merger announcement. Additional cash payments made by PURE Products in completing the acquisition were

Finder's fee paid to firm that located Light Steel	$10,000
Audit fee for stock issued by PURE Products	3,000
Stock registration fee for new shares of PURE Products	5,000
Legal fees paid to assist in transfer of net assets	9,000
Cost of SEC registration of PURE Products shares	1,000

Required

Prepare all journal entries to record the business combination on PURE Products' books.

LO 1-5

P1-35 Purchase at More than Book Value

Ramrod Manufacturing acquired all the assets and liabilities of Stafford Industries on January 1, 20X2, in exchange for 4,000 shares of Ramrod's $20 par value common stock. Balance sheet data for both companies just before the merger are given as follows:

	Ramrod Manufacturing		Stafford Industries	
Balance Sheet Items	**Book Value**	**Fair Value**	**Book Value**	**Fair Value**
Cash	$ 70,000	$ 70,000	$ 30,000	$ 30,000
Accounts Receivable	100,000	100,000	60,000	60,000
Inventory	200,000	375,000	100,000	160,000
Land	50,000	80,000	40,000	30,000
Buildings & Equipment	600,000	540,000	400,000	350,000
Less: Accumulated Depreciation	(250,000)		(150,000)	
Total Assets	$ 770,000	$1,165,000	$ 480,000	$630,000
Accounts Payable	$ 50,000	$ 50,000	$ 10,000	$ 10,000
Bonds Payable	300,000	310,000	150,000	145,000
Common Stock:				
$20 par value	200,000			
$5 par value			100,000	
Additional Paid-In Capital	40,000		20,000	
Retained Earnings	180,000		200,000	
Total Liabilities & Equities	$ 770,000		$ 480,000	

Ramrod shares were selling for $150 on the date of acquisition.

Required

Prepare the following:

a. Journal entries to record the acquisition on Ramrod's books.

b. A balance sheet for the combined enterprise immediately following the business combination.

LO 1-5

P1-36 Business Combination

Following are the balance sheets of Boogie Musical Corporation and Toot-Toot Tuba Company as of December 31, 20X5.

BOOGIE MUSICAL CORPORATION
Balance Sheet
December 31, 20X5

Assets		**Liabilities & Equities**	
Cash	$ 23,000	Accounts Payable	$ 48,000
Accounts Receivable	85,000	Notes Payable	65,000
Allowance for Uncollectible Accounts	(1,200)	Mortgage Payable	200,000

(continued)

Inventory	192,000	Bonds Payable	200,000
Plant & Equipment	980,000	Capital Stock ($10 par)	500,000
Accumulated Depreciation	(160,000)	Premium on Capital Stock	1,000
Other Assets	14,000	Retained Earnings	118,800
Total Assets	$1,132,800	Total Liabilities & Equities	$1,132,800

TOOT-TOOT TUBA COMPANY
Balance Sheet
December 31, 20X5

Assets		**Liabilities & Equities**	
Cash	$ 300	Accounts Payable	$ 8,200
Accounts Receivable	17,000	Notes Payable	10,000
Allowance for Uncollectible Accounts	(600)	Mortgage Payable	50,000
Inventory	78,500	Bonds Payable	100,000
Plant & Equipment	451,000	Capital Stock ($50 par)	100,000
Accumulated Depreciation	(225,000)	Premium on Capital Stock	150,000
Other Assets	25,800	Retained Earnings	(71,200)
Total Assets	$347,000	Total Liabilities & Equities	$347,000

In preparation for a possible business combination, a team of experts from Boogie Musical made a thorough examination and audit of Toot-Toot Tuba. They found that Toot-Toot's assets and liabilities were correctly stated except that they estimated uncollectible accounts at $1,400. The experts also estimated the market value of the inventory at $35,000 and the market value of the plant and equipment at $500,000. The business combination took place on January 1, 20X6, and on that date Boogie Musical acquired all the assets and liabilities of Toot-Toot Tuba. On that date, Boogie's common stock was selling for $55 per share.

Required

Record the combination on Boogie's books assuming that Boogie issued 9,000 of its $10 par common shares in exchange for Toot-Toot's assets and liabilities.

LO 1-5

P1-37 Combined Balance Sheet

Bilge Pumpworks and Seaworthy Rope Company agreed to merge on January 1, 20X3. On the date of the merger agreement, the companies reported the following data:

	Bilge Pumpworks		Seaworthy Rope Company	
Balance Sheet Items	**Book Value**	**Fair Value**	**Book Value**	**Fair Value**
Cash & Receivables	$ 90,000	$ 90,000	$ 20,000	$ 20,000
Inventory	100,000	150,000	30,000	42,000
Land	100,000	140,000	10,000	15,000
Plant & Equipment	400,000	300,000	200,000	140,000
Less: Accumulated Depreciation	(150,000)		(80,000)	
Total Assets	$ 540,000	$680,000	$180,000	$217,000
Current Liabilities	$ 80,000	$ 80,000	$ 20,000	$ 20,000
Capital Stock	200,000		20,000	
Capital in Excess of Par Value	20,000		5,000	
Retained Earnings	240,000		135,000	
Total Liabilities & Equities	$ 540,000		$180,000	

Bilge Pumpworks has 10,000 shares of its $20 par value shares outstanding on January 1, 20X3, and Seaworthy has 4,000 shares of $5 par value stock outstanding. The market values of the shares are $300 and $50, respectively.

Required

a. Bilge issues 700 shares of stock in exchange for all of Seaworthy's net assets. Prepare a balance sheet for the combined entity immediately following the merger.

b. Prepare the stockholders' equity section of the combined company's balance sheet, assuming Bilge acquires all of Seaworthy's net assets by issuing:

1. 1,100 shares of common.
2. 1,800 shares of common.
3. 3,000 shares of common.

LO 1-5

P1-38 Incomplete Data

On January 1, 20X2, End Corporation acquired all of Cork Corporation's assets and liabilities by issuing shares of its common stock. Partial balance sheet data for the companies prior to the business combination and immediately following the combination are as follows:

	End Corp. Book Value	Cork Corp. Book Value	Combined Entity
Cash	$ 40,000	$ 10,000	$ 50,000
Accounts Receivable	60,000	30,000	88,000
Inventory	50,000	35,000	96,000
Buildings & Equipment (net)	300,000	110,000	430,000
Goodwill			?
Total Assets	$450,000	$185,000	$?
Accounts Payable	$ 32,000	$ 14,000	$ 46,000
Bonds Payable	150,000	70,000	220,000
Bond Premium	6,000		6,000
Common Stock, $5 par	100,000	40,000	126,000
Additional Paid-In Capital	65,000	28,000	247,000
Retained Earnings	97,000	33,000	?
Total Liabilities & Equities	$450,000	$185,000	$?

Required

a. What number of shares did End issue to acquire Cork's assets and liabilities?

b. What was the total market value of the shares issued by End?

c. What was the fair value of the inventory held by Cork at the date of combination?

d. What was the fair value of the identifiable net assets held by Cork at the date of combination?

e. What amount of goodwill, if any, will be reported by the combined entity immediately following the combination?

f. What balance in retained earnings will the combined entity report immediately following the combination?

g. If the depreciable assets held by Cork had an average remaining life of 10 years at the date of acquisition, what amount of depreciation expense will be reported on those assets in 20X2?

LO 1-5

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P1-39 Incomplete Data Following Purchase

On January 1, 20X1, Alpha Corporation acquired all of Bravo Company's assets and liabilities by issuing shares of its $3 par value stock to the owners of Bravo Company in a business combination. Alpha also made a cash payment to Banker Corporation for stock issue costs. Partial balance sheet data for Alpha and Bravo, before the cash payment and issuance of shares, and a combined balance sheet following the business combination are as follows:

	Alpha Corporation	Bravo Company		
	Book Value	Book Value	Fair Value	Combined Entity
Cash	$ 65,000	$ 15,000	$ 15,000	$ 56,000
Accounts Receivable	105,000	30,000	30,000	135,000
Inventory	210,000	90,000	?	320,000
Buildings & Equipment (net)	400,000	210,000	293,000	693,000
Goodwill				?
Total Assets	$780,000	$345,000	$448,000	$?
Accounts Payable	$ 56,000	$ 22,000	$ 22,000	$ 78,000
Bonds Payable	200,000	120,000	120,000	320,000
Common Stock	96,000	70,000		117,000
Additional Paid-In Capital	234,000	42,000		553,000
Retained Earnings	194,000	91,000		?
Total Liabilities & Equities	$780,000	$345,000	$142,000	$?

Required

a. What number of its $5 par value shares did Bravo have outstanding at January 1, 20X1?

b. Assuming that all of Bravo's shares were issued when the company was started, what was the price per share received at the time of issue?

c. How many shares of Alpha were issued at the date of combination?

d. What amount of cash did Alpha pay as stock issue costs?

e. What was the total market value of Alpha's shares issued at the date of combination?

f. What was the fair value of Bravo's inventory at the date of combination?

g. What was the fair value of Bravo's net assets at the date of combination?

h. What amount of goodwill, if any, will be reported in the combined balance sheet following the combination?

LO 1-5

P1-40 Comprehensive Business Combination

Bigtime Industries Inc. entered into a business combination agreement with Hydrolized Chemical Corporation (HCC) to ensure an uninterrupted supply of key raw materials and to realize certain economies from combining the operating processes and the marketing efforts of the two companies. Under the terms of the agreement, Bigtime issued 180,000 shares of its $1 par common stock in exchange for all of HCC's assets and liabilities. The Bigtime shares then were distributed to HCC's shareholders, and HCC was liquidated.

Immediately prior to the combination, HCC's balance sheet appeared as follows, with fair values also indicated:

	Book Values	Fair Values
Assets		
Cash	$ 28,000	$ 28,000
Accounts Receivable	258,000	251,500
Less: Allowance for Bad Debts	(6,500)	
Inventory	381,000	395,000
Long-Term Investments	150,000	175,000
Land	55,000	100,000
Rolling Stock	130,000	63,000
Plant & Equipment	2,425,000	2,500,000
Less: Accumulated Depreciation	(614,000)	
Patents	125,000	500,000
Special Licenses	95,800	100,000
Total Assets	$3,027,300	$4,112,500

(continued)

	Book Values	Fair Values
Liabilities		
Current Payables	$ 137,200	$ 137,200
Mortgages Payable	500,000	520,000
Equipment Trust Notes	100,000	95,000
Debentures Payable	1,000,000	950,000
Less: Discount on Debentures	(40,000)	
Total Liabilities	$1,697,200	$1,702,200
Stockholders' Equity		
Common Stock ($5 par)	600,000	
Additional Paid-In Capital from Common Stock	500,000	
Additional Paid-In Capital from Retirement of Preferred Stock	22,000	
Retained Earnings	220,100	
Less: Treasury Stock (1,500 shares)	(12,000)	
Total Liabilities & Equity	$3,027,300	

Immediately prior to the combination, Bigtime's common stock was selling for $14 per share. Bigtime incurred direct costs of $135,000 in arranging the business combination and $42,000 of costs associated with registering and issuing the common stock used in the combination.

Required

a. Prepare all journal entries that Bigtime should have entered on its books to record the business combination.

b. Present all journal entries that should have been entered on HCC's books to record the combination and the distribution of the stock received.