



11th edition

Advanced Accounting Consolidations, Partnerships, and Government Accounting

Fischer
Taylor
Cheng

**International
Edition**

PRESENT VALUE TABLES

Present Value of \$1 Due in n Periods

$$PV = A \left[\frac{1}{(1+i)^n} \right] = A(PVF_{\overline{n}|i})$$

n	2%	3%	4%	5%	6%	8%	10%	12%	16%	20%
1	0.9804	0.9709	0.9615	0.9524	0.9434	0.9259	0.9091	0.8929	0.8621	0.8333
2	0.9612	0.9426	0.9246	0.9070	0.8900	0.8573	0.8264	0.7972	0.7432	0.6944
3	0.9423	0.9151	0.8890	0.8638	0.8396	0.7938	0.7513	0.7118	0.6407	0.5787
4	0.9238	0.8885	0.8548	0.8227	0.7921	0.7350	0.6830	0.6355	0.5523	0.4823
5	0.9057	0.8626	0.8219	0.7835	0.7473	0.6806	0.6209	0.5674	0.4761	0.4019
6	0.8880	0.8375	0.7903	0.7462	0.7050	0.6302	0.5645	0.5066	0.4104	0.3349
7	0.8706	0.8131	0.7599	0.7170	0.6651	0.5835	0.5132	0.4523	0.3538	0.2791
8	0.8535	0.7894	0.7307	0.6768	0.6274	0.5403	0.4665	0.4039	0.3050	0.2326
9	0.8368	0.7664	0.7026	0.6446	0.5919	0.5002	0.4241	0.3606	0.2630	0.1938
10	0.8203	0.7441	0.6756	0.6139	0.5584	0.4632	0.3855	0.3220	0.2267	0.1615
11	0.8043	0.7224	0.6496	0.5847	0.5268	0.4289	0.3505	0.2875	0.1954	0.1346
12	0.7885	0.7014	0.6246	0.5568	0.4970	0.3971	0.3186	0.2567	0.1685	0.1122
13	0.7730	0.6810	0.6006	0.5303	0.4688	0.3677	0.2897	0.2292	0.1452	0.0935
14	0.7579	0.6611	0.5775	0.5051	0.4423	0.3405	0.2633	0.2046	0.1252	0.0779
15	0.7430	0.6419	0.5553	0.4810	0.4173	0.3152	0.2394	0.1827	0.1079	0.0649
16	0.7284	0.6232	0.5339	0.4581	0.3936	0.2919	0.2176	0.1631	0.0930	0.0541
17	0.7142	0.6050	0.5134	0.4363	0.3714	0.2703	0.1978	0.1456	0.0802	0.0451
18	0.7002	0.5874	0.4936	0.4155	0.3503	0.2502	0.1799	0.1300	0.0691	0.0376
19	0.6864	0.5703	0.4746	0.3957	0.3305	0.2317	0.1635	0.1161	0.0596	0.0313
20	0.6730	0.5537	0.4564	0.3769	0.3118	0.2145	0.1486	0.1037	0.0514	0.0261
25	0.6095	0.4776	0.3751	0.2953	0.2330	0.1460	0.0923	0.0588	0.0245	0.0105
30	0.5521	0.4120	0.3083	0.2314	0.1741	0.0994	0.0573	0.0334	0.0116	0.0042
40	0.4529	0.3066	0.2083	0.1420	0.0972	0.0460	0.0221	0.0107	0.0026	0.0007
50	0.3715	0.2281	0.1407	0.0872	0.0543	0.0213	0.0085	0.0035	0.0006	0.0001

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**Advanced Accounting: Consolidations, Partnerships,
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Combined Corporate Entities and Consolidations

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Special Appendix:	<i>Accounting for Influential Investments</i>

The acquisition of one company by another is a commonplace business activity. Frequently, a company is groomed for sale. Also, the recent proliferation of new technology businesses and financial services firms that merge into larger companies is an expected, and often planned for, occurrence. For three decades, prior to 2001, accounting standards for business combinations had remained stable. Two models of recording combinations had coexisted. The pooling-of-interests method brought over the assets and liabilities of the acquired company at existing book values. The purchase method brought the acquired company's assets and liabilities to the acquiring firm's books at fair market value. FASB Statement No. 141, issued in July 2001, ended the use of the pooling method and gave new guidance for recording business combinations under purchase accounting principles.

Two new FASB Statements issued in 2007 brought major changes to accounting for business combinations. FASB Statement 141r required that all accounts of an acquired company be recorded at fair value, no matter the percentage of interest acquired or the price paid. FASB Statement 160 required new rules for accounting for the interest not acquired by the acquiring firm. This interest is known as the noncontrolling interest. It is now recorded at fair value on the acquisition date and is considered a part of the stockholder's equity of the consolidated firm.

The contents of FASB Statements 141r and 160 are now incorporated into FASB ASC 805 and 810, respectively. ASC stands for Accounting Standards Codification. These statements are unique in that they were produced in a joint effort with the International Accounting Standards

Board (IASB). Some minor differences still exist between U.S. GAAP and international rules. They are described in Chapter 2. Throughout this book, a new feature called "IASB Perspectives" will address the ever-changing relationship between U.S. GAAP and International Financial Reporting Standards (IFRS). This feature is not found in all chapters, but has been included where applicable.

There are two types of accounting transactions to accomplish a combination. The first is to acquire the assets and liabilities of a company directly from the company itself by paying cash or by issuing bonds or stock. This is called a *direct asset acquisition* and is studied in Chapter 1. The assets and liabilities of the new company are directly recorded on the parent company's books. All of the theory involving acquisitions is first explained in this context.

The more common way to achieve control is to acquire a controlling interest, usually over 50%, in the voting common stock of another company. The acquiring company simply records an investment account for its interest in the new company. Both companies maintain their own accounting records. However, when two companies are under common control, a single set of *consolidated statements* must be prepared to meet external reporting requirements. The investment account is eliminated and the individual assets and liabilities of the acquired company are merged with those of the parent company. Chapters 2 through 8 provide the methods for consolidating the separate statements of the affiliated firms into a consolidated set of financial statements. The consolidation process becomes a continuous activity, which is further complicated by continuing transactions between the affiliated companies.

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Business Combinations: New Rules for a Long-Standing Business Practice

CHAPTER

1

Learning Objectives

When you have completed this chapter, you should be able to

1. Describe the major economic advantages of business combinations.
2. Differentiate between accounting for an acquisition of assets and accounting for an acquisition of a controlling interest in the common stock of a company.
3. Explain the basics of the acquisition model.
4. Allocate the acquisition price to the assets and liabilities of the acquired company.
5. Demonstrate an understanding of the tax issues that arise in an acquisition.
6. Explain the disclosure that is required in the period in which an acquisition occurs.
7. Apply the impairment test to goodwill and adjust goodwill when needed.
8. Explain special and different rules that apply to acquisitions by companies that are not publicly traded
9. Estimate the value of goodwill. (Appendix)

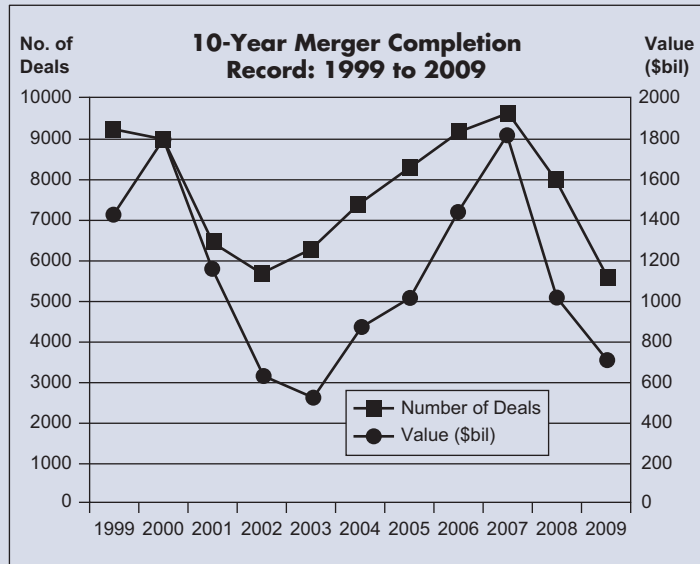
Business combinations have been a common business transaction since the start of commercial activity. The concept is simple: A business combination is the acquisition of all of a company's assets at a single price. *Business combinations* is a comprehensive term covering all acquisitions of one firm by another. Such combinations can be further categorized as either mergers or consolidations. The term *merger* applies when an existing company acquires another company and combines that company's operations with its own. The term *consolidation* applies when two or more previously separate firms join and become one new, continuing company. Business combinations make headlines not only in the business press but also in the local newspapers of the communities where the participating companies are located. While investors may delight in the price received for their interest, employees become concerned about continued employment, and local citizens worry about a possible relocation of the business.

The popularity of business combinations grew steadily during the 1990s and peaked in 1998. From then until 2003, activity slowed considerably, with the dollar amount of deals falling even more than the number of deals. From 2003 to 2007, there was a steady rise in deals and the dollar amount of acquisitions. By 2009, the number of deals and their value fell to roughly half of their 2007 levels. Exhibit 1-1 includes the Merger Completion Record covering 1999 through 2009. The data include all acquisitions in which a U.S. company was involved as either a buyer or seller. The drastic change in business combinations can be attributed to several possible causes, such as the following:

- ◆ The growth period prior to 2002 reflects, in part, the boom economy of that period, especially in high-tech industries. There was also a motivation to complete acquisitions prior to July 1, 2001, when FASB Statement No. 141, *Business Combinations*, became effective. FASB Statement No. 141 eliminated the pooling-of-interests method. Pooling allowed companies to record the acquired assets at existing book value. This meant less depreciation

Exhibit 1-1
10-Year Merger Completion Record: 1999–2009

10-Year Merger Completion Record: 1999 to 2009				
Year	No. of Deals	% Change	Value (\$bil)	% Change
1999	9,248	—	1,423.1	—
2000	8,974	−3.0	1,786.3	25.5
2001	6,423	28.4	1,155.4	−35.3
2002	5,685	−11.5	626.7	−45.8
2003	6,269	10.3	526.9	15.9
2004	7,350	17.2	866.4	64.4
2005	8,249	12.2	1,012.2	16.8
2006	9,141	10.8	1,431.3	41.4
2007	9,575	4.7	1,808.1	26.3
2008	7,917	−17.3	999.2	−44.7
2009	5,514	−30.4	703.1	−29.6



Source: *Mergers and Acquisitions Almanac*, February 2010, p. 31.

and amortization charges in later periods. When the alternative purchase method was used prior to 2001, any goodwill that was recorded could be amortized over 40 years. After 2001, FASB Statement No. 141 required goodwill impairment testing, which meant there was a risk of a major goodwill impairment loss in a future period.

- ♦ The decline in acquisition activity could also be attributed to the soft economy during the post-2001 period. The high-tech sector of the economy, which had been a hotbed of combinations, was especially weak. Add to it the increased scrutiny of companies being acquired, as caused by the accounting and business scandals of the period, and the motivation to acquire was lessened.
- ♦ Aside from broad-based accounting infractions, specific allegations of precombination beautification arose. It became clear that adjustments were made to the books of the company being acquired to make it look more valuable as a takeover candidate. This included arranging in advance to meet the pooling-of-interests criteria and making substantial write-offs to enhance post-acquisition income. In the fall of 1999, it was alleged that Tyco International arranged to have targeted companies take major write-downs before being acquired by Tyco. This concern caused a major decline in the value of Tyco shares and led to stockholder suits against the company.
- ♦ The steady increase in acquisition activity after 2002 could be attributed to a growing economy and stabilization in the accounting method used.
- ♦ The steep decline in activity since 2007 is likely a result of the deep recession during that time period. With improvements in the economy during 2010, business acquisitions have accelerated.

1

OBJECTIVE

Describe the major economic advantages of business combinations.

ECONOMIC ADVANTAGES OF COMBINATIONS

Business combinations are typically viewed as a way to jump-start economies of scale. Savings may result from the elimination of duplicative assets. Perhaps both companies will utilize common facilities and share fixed costs. There may be further economies as one management team replaces two separate sets of managers. It may be possible to better coordinate production, marketing, and administrative actions. The U.S. Federal Trade Commission defines six types of mergers. They are:

Backward Vertical Integration. This is a deal where a company moves down the production–marketing cycle by acquiring a supplier of products or services it provides.

Example: The 2010 acquisition of Smith International by Slumberger. Smith International is a provider of drilling bits and fluids to the oil industry. Slumberger is an oil field service company providing a range of services to oil companies including drilling of oil wells. The transaction was stock for stock and will likely be a tax-free exchange for investors (to be explained in a following section).

Forward Vertical Integration. This is a merger where a company moves up the production–marketing cycle by acquiring a company that uses its products.

Example: The 2010 acquisition of Healthvision Solutions, Inc., by Lawson Software. Lawson is a provider of software solutions including healthcare applications. Healthvision provides integrated healthcare technologies directly to healthcare organizations. This was an acquisition for cash.

Horizontal Merger. This is a 2010 merger of companies that offer similar products or services and are likely competitors in the same market space.

Example: The huge drug store chain, Walgreen Company, acquired the New-York-based drug store chain of Duane Reade Holdings, Inc. This cash acquisition quadrupled the number of stores Walgreen has in the metro New York area.

Product Extension Merger. This is a merger where the acquiring company is expanding its product offerings in the marketplace in which it already sells products and/or services.

Example: In early 2010, R. R. Donnelley & Sons Company acquired, for cash, Browne & Company. Donnelley provides integrated communication services for a wide range of customers. Browne provides critical capital markets communications.

Market Extension Merger. This merger increases the geographic market coverage of the same products or services already offered by the acquiring company.

Example: In 2010, First Energy acquired Allegheny Energy. Both companies are power companies. The acquisition expands First Energy's market in Pennsylvania and extends its market to include portions of West Virginia, Maryland, and Virginia.

Conglomerate Merger. Example: This is an acquisition of a firm in an unrelated line of business. In effect, the acquiring firm has a portfolio of investments. Some have said that a conglomerate is similar to a mutual fund in its purpose to maximize returns over a range of companies.

In early 2010, Thomas H. Lee Partners acquired for cash CKE Restaurants, Inc. CKE owns the Carl's Jr. and Hardee's quick service restaurant chains. Thomas H. Lee Partners businesses include information services, lending, publishing, music, and consumer products, including Snapple.

Tax Advantages of Combinations

Perhaps the most universal economic benefit in business combinations is a possible tax advantage. The owners of a business, whether sole proprietors, partners, or shareholders, may wish to retire from active management of the company. If they were to sell their interest for cash or accept debt instruments, they would have an immediate taxable gain. If, however, they accept the common stock of another corporation in exchange for their interest and carefully craft the transaction as a “tax-free reorganization,” they may account for the transaction as a tax-free exchange. No taxes are paid until the shareholders sell the shares received in the business combination. The shareholder records the new shares received (for tax purposes) at the book value of the exchanged shares.

In early 2005, SBC proposed to acquire AT&T. The following information was proposed to shareholders:

AT&T shareholders will receive .7792 shares of SBC common stock for each share of AT&T. Based on SBC's closing stock price on January 28, 2005, this exchange ratio equals \$18.41 per share. In addition, at the time of closing AT&T will pay its shareholders a special dividend of \$ 1.30 per share. The stock consideration in the transaction is expected to be tax free to AT&T shareholders.¹

¹ AT&T News Release, 2005-02-22, AT&T Formally Begins Merger Approval Process, <http://www.corp.att.com/news/2005/02/22>.

Further tax advantages exist when the target company has reported losses on its tax returns in prior periods. Section 172 of the Internal Revenue Code provides that operating losses can generally be carried back two years to obtain a refund of taxes paid in previous years. In an effort to stimulate the economy, Congress enacted a special 5-year carryback for 2008 and 2009 operating losses. Should the loss not be offset by income in the allowed prior years, the loss may be carried forward up to 20 years to offset future taxable income, thus eliminating or reducing income taxes that would otherwise be payable. These loss maneuvers have little or no value to a target company that has not had income in the two prior years and does not expect profitable operations in the near future. However, tax losses are transferable in a business combination. To an acquiring company that has a profit in the current year and/or expects profitable periods in the future, the tax losses of a target company may have real value. That value, viewed as an asset by the acquiring company, will be reflected in the price paid. However, the acquiring company must exercise caution in anticipating the benefits of tax loss carryovers. The realization of the tax benefits may be denied if it can be shown that the primary motivation for the combination was the transfer of the tax loss benefit.

A tax benefit may also be available in a subsequent period as a consolidated tax return is filed by the single remaining corporation. The losses of one of the affiliated companies can be used to offset the net income of another affiliated company to lessen the taxes that would otherwise be paid by the profitable company.

REFLECTION

- Business combinations may have a wide range of economic advantages to a firm including vertical and horizontal integration, market and product expansion and diversification as a conglomerate company.
- Potential sellers may be motivated by the tax advantages available to them in a business combination.

2

OBJECTIVE

Differentiate between accounting for an acquisition of assets and accounting for an acquisition of a controlling interest in the common stock of a company.

ACQUISITION OF CONTROL

Control of another company may be achieved by either acquiring the assets of the target company or acquiring a controlling interest (typically over 50%) in the target company's voting common stock. In an *acquisition of assets*, all of the company's assets are acquired *directly* from the company. In most cases, existing liabilities of the acquired company also are assumed. When assets are acquired and liabilities are assumed, we refer to the transaction as an acquisition of "net assets." Payment could be made in cash, exchanged property, or issuance of either debt or equity securities. It is common to issue securities since this avoids depleting cash or other assets that may be needed in future operations. Legally, a *statutory consolidation* refers to the combining of two or more previously independent legal entities into one new legal entity. The previous companies are dissolved and are then replaced by a single continuing company. A *statutory merger* refers to the absorption of one or more former legal entities by another company that continues as the sole surviving legal entity. The absorbed company ceases to exist as a legal entity but may continue as a division of the surviving company.

In a *stock acquisition*, a controlling interest (typically, more than 50%) of another company's voting common stock is acquired. The company making the acquisition is termed the *parent* (also the acquirer), and the company acquired is termed a *subsidiary* (also the acquiree). Both the parent and the subsidiary remain separate legal entities and maintain their own financial records and statements. However, for external financial reporting purposes, the companies usually will combine their individual financial statements into a single set of consolidated statements. Thus, the term "consolidation" may refer to a statutory combination or, more commonly, to the consolidated statements of a parent and its subsidiary.

There may be several advantages to obtaining control by acquiring a controlling interest in stock. The most obvious one is that the total cost is lower, since only a controlling interest in the assets, and not the total assets, must be acquired. In addition, control through stock ownership may be simpler to achieve since no formal negotiations or transactions with the acquiree's management are necessary. Further advantages may result from maintaining the separate legal identity of the acquiree company. First of all, risk is lowered because the legal liability of each corporation is limited to its own assets. Secondly, separate legal entities may be desirable when only one of the companies, such as a utility company, is subject to government control. Lastly, tax advantages may result from the preservation of the legal entities.

Stock acquisitions are said to be “friendly” when the stockholders of the acquiree corporation, as a group, decide to sell or exchange their shares. In such a case, an offer may be made to the board of directors by the acquiring company. If the directors approve, they will recommend acceptance of the offer to the shareholders, who are likely to approve the transaction. Often, a two-thirds vote is required. Once approval is gained, the exchange of shares will be made with the individual shareholders. If the officers decline the offer, or if no offer is made, the acquirer may deal directly with individual shareholders in an attempt to secure a controlling interest. Frequently, the acquirer may make a formal *tender offer*. The tender offer typically will be published in newspapers and will offer a greater-than-market price for shares made available by a stated date. The acquirer may reserve the right to withdraw the offer if an insufficient number of shares is made available to it. Where management and/or a significant number of shareholders oppose the acquisition of the company by the intended buyer, the acquisition is viewed as hostile. Unfriendly offers are so common that several standard defensive mechanisms have evolved. Following are the common terms used to describe these defensive moves.

Greenmail. The target company may pay a premium price (“greenmail”) to buy back its own shares. It may either buy shares already owned by a potential acquiring company or purchase shares from a current owner who, it is feared, would sell to the acquiring company. The price paid for these shares in excess of their market price may not be deducted from stockholders' equity; instead, it is expensed.²

White Knight. The target company locates a different company to acquire a controlling interest. This could occur when the original acquiring company is in a similar industry and it is feared that current management of the target company would be displaced. The replacement acquiring company, the “white knight,” might be in a different industry and could be expected to keep current management intact.

Poison Pill. The “poison pill” involves the issuance of stock rights to existing shareholders to purchase additional shares at a price far below fair value. However, the rights are exercisable only when an acquiring company purchases or makes a bid to purchase a stated number of shares. The effect of the options is to substantially raise the cost to the acquiring company. If the attempt fails, there is at least a greater gain for the original shareholders.

Selling the Crown Jewels. This approach has the management of the target company selling vital assets (the “crown jewels”) of the target company to others to make the company less attractive to the acquiring company.

Leveraged Buyouts. The management of the existing target company attempts to purchase a controlling interest in that company. Often, substantial debt will be incurred to raise the funds needed to purchase the stock; hence the term “leveraged buyout.” When bonds are sold to provide this financing, the bonds may be referred to as “junk bonds,” since they are often high-interest and high-risk due to the high debt-to-equity ratio of the resulting corporation.

Further protection against takeovers is offered by federal and state law. The Clayton Act of 1914 (Section 7) is a federal law that prohibits business combinations in which “the effect of such acquisition may be substantially to lessen competition or to tend to create a monopoly.”

² FASB ASC 505-30-25-4, *Equity-Treasury Stock—Recognition* (Norwalk, CT, 2010).

The Williams Act of 1968 is a federal law that regulates tender offers; it is enforced by the Securities and Exchange Commission (SEC). Several states also have enacted laws to discourage hostile takeovers. These laws are motivated, in part, by the fear of losing employment and taxes.

Accounting Ramifications of Control

When control is achieved through an asset acquisition, the acquiring company records on its books the assets and assumed liabilities of the acquired company. From the acquisition date on, all transactions of both the acquiring and acquired company are recorded in one combined set of accounts. The only new skill one needs to master is the proper recording of the acquisition when it occurs. **Once the initial acquisition is properly recorded, subsequent accounting procedures are the same as for any single accounting entity.** Combined statements of the new, larger company for periods following the combination are automatic.

Accounting procedures are more involved when control is achieved through a stock acquisition. The controlling company, the parent, will record only an investment account to reflect its interest in the controlled company, the subsidiary. Both the parent and the subsidiary remain separate legal entities with their own separate sets of accounts and separate financial statements. Accounting theory holds that where one company has effective control over another, there is only one economic entity and there should be only one set of financial statements that combines the activities of the entities under common control. The accountant will prepare a worksheet, referred to as the *consolidated worksheet*, that starts with the separate accounts of the parent and the subsidiary. Various adjustments and eliminations will be made on this worksheet to merge the separate accounts of the two companies into a single set of financial statements, which are called *consolidated statements*.

This chapter discusses business combinations resulting from asset acquisitions, since the accounting principles are more easily understood in this context. The principles developed are applied directly to stock acquisitions that are presented in the chapters that follow.

REFLECTION

- Control of another company is gained by either acquiring all of that firm's assets (and usually its liabilities) or by acquiring a controlling interest in that company's voting common stock.
- Control through an acquisition of assets requires the correct initial recording of the purchase. Combined statements for future periods are automatically produced.

3

OBJECTIVE

Explain the basics of the acquisition model.

EVOLUTION OF ACCOUNTING METHODS

Prior to the issuance of FASB Statement No. 141 in 2001, two methods were used to account for business combinations. These were the purchase method and the pooling-of-interests method. The *purchase method* usually recorded all assets and liabilities of the company acquired at fair value. The purchase method was the primary method in use. However, under some circumstances, the pooling-of-interests method was allowed. The *pooling-of-interests method* recorded the assets and liabilities of the acquired firm at their existing book values. This method was intended to be applied to business combinations that were a "merger of equals." Specific criteria existed as to combinations that would qualify. Ninety percent of the stock of the firm acquired had to be received in exchange for the shares of the acquiring firm. All shareholders of the acquired firm had to be treated equally. Numerous other criteria also attempted to guarantee a fusion of existing owners rather than a takeover of one company by another. In the end, some companies engaged in a series of equity transactions prior to the combination so that they would be able to meet the pooling criteria. Pooling allowed the carry over of book values to the acquiring firm. That resulted in greater future income because of typically lower depreciation

and amortization charges on assets. Pooling did not result in new goodwill being recorded. At that time goodwill was amortized. Thus, pooling also led to greater income in the future since there would be no goodwill amortization.

FASB Statement No. 141 eliminated the pooling method. Assets and liabilities acquired in a pooling of interests, that began prior to the effective date of FASB Statement No. 141, were allowed to continue as originally recorded. This means that current-era financial statements still include assets and liabilities of a firm acquired in a pooling that were initially recorded at their book values on the acquisition date.

The purchase method required under FASB Statement No. 141 focused only on recording fair values for the portion of the assets and liabilities acquired in the purchase. The accounts of the acquired company would only be adjusted to full fair value if the parent company acquired a 100% interest in the acquired firm. If, for example, the purchasing company bought only an 80% interest in the acquired firm, accounts would be adjusted by only 80% of the difference between book and fair value. Thus, in an 80% purchase, an asset with a book value of \$6,000 and a fair value of \$10,000 would be recorded at \$9,200 (\$6,000 book value plus 80% × \$4,000 excess of fair value over book value).

The new *acquisition method* included in FASB Statement No. 141r (now included in FASB ASC 805), issued in 2007, requires that all assets and liabilities be recorded at fair value regardless of the percentage interest purchased by the acquiring company (provided that the interest purchased is large enough to constitute a controlling interest). In the above example, the asset illustrated would be recorded at the full \$10,000 fair value even though the acquiring company only purchased an 80% interest in the company that owns the asset. The acquisition method also eliminated the prior practice of discounting of fixed and intangible assets to a value less than fair value. This would happen under the purchase method when, in a rare case, the acquiring firm made a “bargain purchase.” A *bargain purchase* occurs when the price paid for a company is less than the sum of the fair value of its net assets (sum of all assets minus all liabilities).

Applying the Acquisition Method

The four steps in the acquisition method are as follows:

1. Identify the acquirer.
2. Determine the acquisition date.
3. Measure the fair value of the acquiree (the company being acquired).
4. Record the acquiree’s assets and liabilities that are assumed.

Identify the Acquirer. In an asset acquisition, the company transferring cash or other assets and/or assuming liabilities is the acquiring company. In a stock acquisition, the acquirer is, in most cases, the company transferring cash or other assets for a controlling interest in the voting common stock of the acquiree (company being acquired). Some stock acquisitions may be accomplished by exchanging voting common stock. Most often, the company issuing the voting common stock is the acquirer. In some cases, the acquiree may issue the stock in the acquisition. This “reverse acquisition” may occur when a publicly traded company is acquired by a privately traded company. The appendix at the end of Chapter 2 considers this situation and provides the applicable accounting methods.

When an acquisition is accomplished through an exchange of equity interests, the factors considered in determining the acquirer firm include the following:

1. Voting rights—The entity with the largest share of voting rights is typically the acquirer.
2. Large minority interest—Where the company purchases only a large minority interest (under 50%) and no other owner or group has a significant voting interest, the company acquiring the large minority interest is likely the acquirer. Determination of control could be based on domination of the decision-making process to obtain the related economic benefits.
3. Governing body of combined entity—The entity that has the ability to elect or appoint a majority of the combined entity is likely the acquirer.
4. Terms of exchange—Typically, the acquirer pays a premium over the precombination market value of the shares acquired.

Determine the Acquisition Date. This is the date that the acquiring firm makes payment by transferring assets, issuing stock, and assuming the liabilities of the acquired company. Normally, this is also the legal closing date. The closing can, however, occur after the acquisition date if there is a written agreement that the acquirer obtains control of the acquiree.

The acquisition date is critical because it is the date used to establish the total fair value of the company acquired, and it is usually the date that fair values are established for the assets and liabilities of the acquired company.

Measure the Fair Value of the Acquiree. Unless there is evidence to the contrary, the fair value of the acquiree as an entity is assumed to be the price paid by the acquirer. The price paid is based on the sum of the fair values of the assets transferred, liabilities assumed, and the stock issued by the acquirer. If the information to establish the fair value of the acquiree is not available on the acquisition date, a *measurement period* is available to ascertain the value. This period ends when either the needed information is available or is judged to not be obtainable. In no case can the measurement period exceed one year after the acquisition date.

Specific guidance as to what may be included in the price calculation is as follows:

- a. The price includes the estimated value of contingent consideration. Contingent consideration is an agreement to issue additional consideration (assets or stock) at a later date if specified events occur. The most common agreements focus on a targeted sales or income performance by the acquiree company. An estimate must be made of the probable settlement cost and that amount is included in the price paid. The measurement period is available to refine the estimated value. Contingent agreements that result in the issue of stock are not remeasured. Subsequent to the measurement period, agreements that create a liability are remeasured and the changes are included in the income of the subsequent period.
- b. The costs of accomplishing the acquisition, such as accounting costs and legal fees, are not included in the price of the company acquired and are expensed. In the period of the acquisition, the notes to the financial statements must disclose the amount of the acquisition costs and state the line item expense on the income statement that includes these costs. Where the consideration used is the stock of the acquirer, the issue costs may also be expensed or they can be deducted from the value assigned to paid-in capital in excess of par, but they are not included in the price paid. This text will deduct issue costs from paid-in capital in excess of par in examples, exercises and problems.

Record the Acquiree's Assets and Liabilities That Are Assumed. The fair values of all identifiable assets and liabilities of the acquiree are determined and recorded. *Fair value* is the amount that the asset or liability would be bought or sold for in a current, normal (nonforced) sale between willing parties. Fair values are determined following the guidance of FASB ASC 820, *Fair Value Measurement and Disclosure*. FASB ASC 820-10-35-39 provides a hierarchy of values, where the highest level measurement possible should be used. The hierarchy is as follows:

- ◆ Level 1—Unadjusted quoted market value in an actively traded market. This method would apply to actively traded investments and to inventory.
- ◆ Level 2—Adjusted market value based on prices of similar assets or on observable other inputs such as interest rates. This approach might apply to work-in-process inventory and plant and equipment that sells in an organized market.
- ◆ Level 3—Fair value based on unobservable inputs, such as the entities' best estimate of an exit (sale) value. The value of plant and equipment, not normally sold in an active market, would likely be calculated under this approach.

There are a few exceptions to the fair value rule that will be discussed. The sum of all identifiable assets, less liabilities recorded, is referred to as the fair value of the net assets. The identifiable assets never include goodwill that may exist on the acquiree's books. The only goodwill recorded in an acquisition is "new" goodwill based on the price paid by the acquirer. The fair value recorded for the net assets is not likely to be equal to the fair value of the acquiree as an entire entity (which is normally equal to the price paid).

Goodwill. Goodwill results when the price paid exceeds the fair value of the acquiree's net identifiable assets. The excess of the fair value of the acquiree over the values assigned to net

identifiable assets is “new” goodwill. The goodwill recorded is not amortized but is impairment tested in future accounting periods.

Bargain Purchase. A bargain purchase occurs when the fair value assigned to the net identifiable assets exceeds the price paid. When this occurs, every effort should be made to revalue the amounts assigned to net identifiable assets to eliminate the difference. If, after reconsideration of the fair values, an excess of fair value of the net identifiable assets over the price paid still exists, the excess is recorded as a “gain” on the acquisition by the acquirer. Disclosure for the period of the acquisition must show the gain as a separate line item on the income statement or identify the line item that includes the gain. Exhibit 1-2, The Combined Income Statement and related note for Sapphire Wines LLC—Emerald Wines LLC, shows a “Gain on bargain purchase of a business” among “Other income (expense) items” in the income statement. Note 3 explains the calculation of the gain.

Exhibit 1-2
Combined Statements of Operation

	Six Months Ended June 30, 2009 (unaudited)	Six Month Ended June 30, 2008 (unaudited)	Year Ended December 31, 2008	Period from March 20, 2007 (inception) to December 31, 2007
Net sales	\$ 8,319,703	\$5,685,506	\$13,611,015	\$5,289,614
Cost of sales	<u>5,085,652</u>	<u>2,776,101</u>	<u>7,340,035</u>	<u>3,689,376</u>
Gross Profit	3,234,051	2,909,405	6,270,980	1,600,238
Selling, general and administrative expenses	<u>2,314,524</u>	<u>1,553,422</u>	<u>3,506,517</u>	<u>662,008</u>
Income from operations	919,527	1,355,983	2,764,463	938,230
Other (income) and expense				
Gain on bargain purchase of business	(1,835,928)	—	—	—
Income from solar power agreement	(128,758)	—	—	—
Interest income	—	—	(906)	(3,474)
Interest expense	1,465,564	1,231,686	2,529,766	778,159
Other (income) expense	<u>(64,198)</u>	<u>—</u>	<u>2,598</u>	<u>17,486</u>
Other (income) and expense-net	<u>(563,320)</u>	<u>1,231,686</u>	<u>2,531,458</u>	<u>792,171</u>
Net income	<u>\$ 1,482,847</u>	<u>\$ 124,297</u>	<u>\$ 233,005</u>	<u>\$ 146,059</u>

**Sapphire Wines, LLC
Emerald Wines, LLC
Notes to Combined Financial Statements**

Note 3—Business combinations

Acquisition of Briarcliff Wine Group, LLC (unaudited). As part of the purchase agreement, the sellers may also receive up to approximately \$1,524,000 should all of the purchased wine inventory be sold within a ten-year period. The approximate pay out schedule based on the Company’s projected case sales are as follows: 2009 – \$47,000; 2010 – \$1,440,000 and 2011 – \$37,000. These contingent payment are recorded at their approximate fair value of \$1,447,000 on the balance sheet as a current obligation.

(continued)

The aggregate purchase price was approximately \$3,447,000. The following summarizes the estimated fair values, using level 3 inputs, of the assets acquired at the date of acquisition. The estimated fair values are subject to change pending a final analysis of the total purchase price and the fair value of the assets acquired, a gain of approximately \$1,835,928 reflecting the bargain purchase of Briarcliff was reflected in the results of operations for the six months ended June 30, 2009.

Inventories	\$3,957,696
Intangible assets-brand	\$1,325,000

Proforma effect of acquisition (unaudited). The purchase of Briarcliff has been included in the financial statement of the company since March 9, 2009.

The unaudited proforma information below presents the results of operations as if the acquisitions of Briarcliff had occurred on the first day of the preceding year. The unaudited proforma information is presented for informational purposes only and is not intended to represent or be indicative of the results of operations of the combined companies had these events occurred at the beginning of the year presented nor is it indicative of future results:

	Six Months June 30 2009	Six Months Ended June 30, 2008	Year Ended December 31, 2008	Period from March 20, 2007 (inception) to December 31, 2007
Total revenue	\$8,789,718	\$7,307,722	\$16,846,791	\$7,879,330
Net income (loss)	<u>\$1,515,561</u>	<u>\$ (335,145)</u>	<u>\$ (683,878)</u>	<u>\$ 62,637</u>

Note 4—Inventories

A summary of inventories by entity consists of the following:

	June 30, 2009 (unaudited)	December 31, 2008	December 31, 2007
Raw materials	\$ 447,292	\$ 485,133	\$ 496,677
Bulk wine	8,720,773	9,007,186	6,006,823
Finished goods	4,874,385	1,988,595	1,880,389
Tasting room	120,529	114,294	87,060
	<u>\$14,162,979</u>	<u>\$11,595,210</u>	<u>\$8,470,949</u>

Note 5—Property, plant and equipment

A summary of property, plant and equipment by entity consists of the following

	June 30, 2009 (unaudited)	December 31, 2008	December 31, 2007
Land	\$ 1,447,051	\$ 1,447,051	\$ 638,660
Building	16,570,639	16,446,530	15,844,828
Computers and equipment	42,000	15,122	15,122
Furniture and fixtures	96,234	93,811	59,412
Winery equipment and fixtures	3,313,660	3,310,942	3,010,215
Vehicles	32,500	32,500	32,500
Barrels	707,427	707,427	502,495
Leasehold improvements	1,709,132	1,697,625	23,575
Construction in progress	35,358	35,358	61,643
	<u>23,954,091</u>	<u>23,786,366</u>	<u>20,188,450</u>
Loss accumulated depreciation	<u>(3,152,510)</u>	<u>(2,214,380)</u>	<u>(598,323)</u>
	<u>\$20,801,581</u>	<u>\$21,571,986</u>	<u>\$19,590,127</u>

(continued)

Included in property, plant and equipment is certain equipment which is leased under capital lease agreements. The combined balance sheets include the following capital leases:

	June 30, 2009 (unaudited)	December 31, 2008	December 31, 2007
Equipment under capital leases	\$ 412,444	\$ 412,441	\$412,441
Accumulated amortization	(245,372)	(180,032)	(49,351)
Net equipment under capital leases	<u>\$ 167,069</u>	<u>\$ 232,409</u>	<u>\$363,090</u>

Prior to FASB 141r, there was an extraordinary gain when the price paid exceeded the total of only current assets minus all liabilities. Under current rules, there is an “ordinary” gain when fair value of the net identifiable assets exceeds the price paid.

REFLECTION

- The acquisition method records all accounts of the acquiree at fair value. Any goodwill on the acquiree’s books is ignored.
- An acquisition cost in excess of the fair value of the acquiree’s net identifiable assets results in goodwill.
- An acquisition cost less than the fair values of the acquiree’s net identifiable assets results in an ordinary gain being recorded by the acquirer.

VALUATION OF IDENTIFIABLE ASSETS AND LIABILITIES

The first step in recording an acquisition is to record the existing asset and liability accounts (except goodwill). As a general rule, assets and liabilities are to be recorded at their individually determined fair values. The preferred method is quoted market value when an active market for the item exists. Where there is not an active market, independent appraisals, discounted cash flow analysis, and other types of analysis are used to estimate fair values. There are some exceptions to the use of fair value that apply to accounts such as assets for resale and deferred taxes.

The acquiring firm is not required to establish values immediately on the acquisition date. A measurement period of up to one year is allowed for measurement. Temporary values would be used in financial statements prepared prior to the end of the measurement period. A note to the statements would explain the use of temporary values. Any change in the recorded values is adjusted retroactively to the date of the acquisition. Prior-period statements are revised to reflect the final values and any related amortizations.

The procedures for recording the assets and liabilities of the acquired firm are as follows:

1. **Current assets**—These are recorded at estimated fair values. This would include recording accounts and notes receivable at the estimated amounts to be collected. Accounts and notes receivable are to be recorded in a net account that represents the probable cash flows; a separate valuation account for uncollectible accounts is not allowed. All accounts share the rule that only the net fair value is recorded, and valuation accounts are not used.
2. **Existing liabilities**—These are also recorded at fair value. For current contractual liabilities, that is likely to be the existing recorded value. For estimated liabilities, a new fair value may be used in place of recorded values. Long-term liabilities will be adjusted to a value different from recorded value if there has been a material change in interest rates.

4

OBJECTIVE

Allocate the acquisition price to the assets and liabilities of the acquired company.

3. **Property, plant, and equipment**—Operating assets will require an estimate of fair value and will be recorded at that net amount with no separate accumulated depreciation account.
4. **Existing intangible assets, other than goodwill**—These will also be recorded at estimated fair value. The valuation of these items, such as patents and copyrights, will typically require the use of discounted cash flow analysis.
5. **Assets that are going to be sold rather than used in operations**—Such assets are *not* recorded at fair value. They are recorded at net realizable value and are listed as current assets.
6. **When the acquiree is a lessee with respect to assets in use**—The original classification of a lease as operating or capital is not changed by the acquisition unless the terms of the lease are modified as part of the acquisition. The acquiree has no recorded asset for assets under operating leases. If, however, the terms of the lease are favorable as compared to current market rent rates, an intangible asset would be recorded equal to the discounted present value of the savings. If the lease terms are unfavorable, an estimated liability would be recorded equal to the discounted present value of the rent in excess of fair rental rates.

EXAMPLE

The acquiree is a party to a 5-year remaining term operating lease requiring payments of \$1,000 per month at the start of each month. The current rental rate for such an asset on a new 5-year lease would be \$1,300 per month. Assuming an annual interest rate for this type of transaction of 8%, the calculation would be as follows:

Payment	\$ 300 (excess of fair rent value over contractual amount)
n	60
Rate	8/12%
Present Value	\$14,894 (beginning mode)

An intangible asset, Favorable Operating Lease Terms, would be recorded and amortized over five years. The effective interest method of amortization should be applied.

If the acquiree is a party to a capital lease, the asset would be recorded at fair value as would the liability under the capital lease.

7. **When the acquiree may have acted as a lessor**—Again, the classification of the lease is not changed unless the terms are changed. For operating leases, the acquiree has the asset recorded on its balance sheet. The asset is recorded at fair value, and it is not impacted by the terms of any lease applicable to that asset. If the terms of the operating lease include rental rates that are different than current rental rates, an intangible asset or estimated liability is recorded. An intangible asset would be recorded for favorable lease terms, and an estimated liability would be recorded for unfavorable terms. Note that the lessor terms are favorable when the contract rental rate exceeds fair rental value, and terms are unfavorable when the fair rental value exceeds the contract rate. The value of the intangible asset or estimated liability uses the same procedure as illustrated for the lessee above.

If the lease is a capital lease, the acquiree has no asset recorded other than the minimum lease payments receivable account. This account would be remeasured at the discounted present value of the payments at the current market interest rate for such a transaction.

EXAMPLE

The acquiree/lessor has a minimum lease payment receivable on its books at \$178,024 (96 beginning-of-the-month payments of \$2,500 at 8% annual interest rate). If the current market rate of interest for this transaction is 12% annual, the fair value of the minimum lease payment receivable would be calculated and recorded as follows:

Payment	\$ 2,500, beginning of the month
n	96 months
Rate	12%/12 = 1%
Present Value	\$155,357 (This is the amount of the minimum lease payment receivable that would be recorded.)

8. **Intangible assets not currently recorded by the acquiree**—Identifiable intangible assets must be separately recorded; their value cannot be swept into the “goodwill” classification. An intangible asset is identifiable if it arises from contractual or other legal rights (even if it is not separable) or is separable. For example, the acquiree may have a customer list that could be sold separately and has a determinable value. The acquiree cannot record the value of this self-developed intangible asset. However, this value must be estimated and recorded as one of the assets acquired in the acquisition.

FASB ASC 805-20-55 provides the following list of possible intangible assets and classifies them as contractual/legal versus only separable.³

Contractual/Legal	Separable
Trademarks, copyrights, trade names, service marks, collective marks, certification marks	Customer lists
Trade dress (unique color shape or package design)	Noncontractual customer relationships
Newspaper mastheads	Unpatented technology
Internet domain names	
Noncompetition agreements	
Order or production backlog	Databases
Customer contracts and related customer relationships	
Plays, operas, ballets	
Books, magazines, newspapers, and other literary works	
Musical works such as compositions, song lyrics, advertising jingles	
Pictures, photographs	
Video and audiovisual material, including motion pictures or films, music videos, television programs	
Licensing, royalty, standstill agreements	
Advertising, construction, management services, or supply contracts	
Lease agreements (applicable to lessees and lessor)	
Construction permits	
Franchise agreements	
Operating and broadcast rights	
Servicing contracts	
Employment contracts	
Use rights, such as for water, timber, air, minerals, or routes	
Patented technology	
Computer software	
Trade secrets	

Note that an assembled workforce is specifically stated in ASC 805-20-55-6 as not qualifying as an identifiable intangible asset. Whatever value it has would be included in the value recorded for goodwill.

³ FASB ASC 805-20-55, *Business Combinations—Identifiable Assets and Liabilities and any Noncontrolling Interest—Implementation and Guidance* (Norwalk, CT, 2010).

9. **Research and development assets**—The fair values of both tangible and intangible research and development assets are recorded even where the assets do not have alternative future uses (the usual criteria for capitalization of R&D assets). Where the assets included in the acquisition have value only for a given project, the assets are considered to have an “indefinite” life and are not amortized until the project is completed. Upon completion, the useful life is to be estimated and used as the amortization period. The assets are to be expensed at the completion or abandonment of an unsuccessful project.

Tangible and intangible R&D assets that are used for multiple R&D projects are separately recorded and are amortized based on the projects served by the assets.

10. **Contingent assets and liabilities**—This refers to contingent assets and liabilities possessed by the acquiree on the acquisition date and must not be confused with contingent consideration that is part of the acquisition agreement. The fair value of a contingent asset or liability is recorded at its fair value on the acquisition date, if such a value exists. The measurement period allows added time to estimate these values.

If a fair value does not exist on the acquisition date, guidance for estimating the value comes from FASB ASC 805-25-20. Two criteria must be met for an estimate of the contingent asset or liability to be recorded:

- ◆ Information available by the end of the measurement date indicates that it is probable that an asset existed or a liability had been incurred as of the acquisition date. It is implicit in this condition that it must be probable at the acquisition date that one or more future events confirming the existence of the asset or liability will occur.
- ◆ The amount of the asset or liability can be reasonably estimated.

Examples of contingent assets would include possible bonuses, refunds stemming from tax disputes, and possible favorable outcomes of lawsuits. Contingent assets can not be recorded except as a part of a business acquisition. Contingent liabilities include pending claims such as unfavorable lawsuits, warranty costs, premiums and coupons, and environmental liabilities.

11. **Liabilities associated with restructuring or exit activities**—The fair value of an existing restructuring or exit activity for which the acquiree is obligated is recorded as a separate liability. To record a liability, there must be an existing obligation to other entities.⁴ The possible future costs connected with restructuring or exit activities that may be planned by the acquirer are not part of the cost of the acquisition and are expensed in future periods.
12. **Employee benefit plans**—The asset or liability under employee benefit plans is not recorded at fair value. Instead, a liability is recorded if the projected benefit obligation exceeds the plan assets. An asset is recorded when the plan assets exceed the projected benefit obligation. The same procedure is applicable to other employee benefit plans.
13. **Deferred taxes**—Some acquisitions will be structured as nontaxable exchanges as to the acquiree. In such cases, the acquirer must continue to base deductions for amortization or depreciation of acquired accounts on their existing tax basis. A deferred tax liability is recorded for added estimated taxes caused by the excess of fair value depreciation over book value depreciation. A deferred tax asset is recorded for estimated future tax savings.

The acquirer would also record deferred tax assets or liabilities for temporary tax differences, such as using straight-line depreciation for financial reporting and an accelerated depreciation method for tax purposes.

The acquirer will also record a deferred tax asset for any operating tax losses or investment credit carryovers acquired from the acquiree.

Taxation issues are considered in the “Tax Issues” section of this chapter.

Applying the Acquisition Model

Let us assume that the Johnson Company to be acquired by Acquisitions, Inc., has the following balance sheet on the October 1, 2017, acquisition date:

⁴ FASB ASC 420-10-25-2, *Exist or Disposal Cost Obligations—Overall—Recognition* (Norwalk, CT, 2010).

Johnson Company
Balance Sheet
October 1, 2017

Cash	\$ 40,000	Current liabilities	\$ 25,000
Marketable investments	60,000	8%, 5-year bond payable	100,000
Inventory	100,000	Total liabilities	\$125,000
Land	30,000	Common stock (\$1 par)	\$ 10,000
Buildings (net)	150,000	Paid-in capital in excess of par	140,000
Equipment (net)	80,000	Retained earnings	185,000
		Total equity	\$335,000
Total assets	<u>\$460,000</u>	Liabilities plus equity	<u>\$460,000</u>

Note 1: A customer list with significant value exists.

Note 2: There is an unrecorded warranty liability on prior-product sales.

Fair values for all accounts have been established as of October 1, 2017 as follows:⁵

Account	Method of Estimation	Fair Value
Cash	Book value	\$ 40,000
Marketable investment	Level 1—Market value	66,000
Inventory	Level 1—Market value	110,000
Land	Level 2—Adjusted market value	72,000
Buildings	Level 2—Adjusted market value	288,000
Equipment	Level 1—Market value	145,000
Customer list	Level 3—Other estimate, discounted cash flow based on estimated future cash flows	125,000
Total assets		\$ 846,000
Current liabilities	Book value	\$ (25,000)
Bonds payable	Face value (adjusted with premium/discount)	(100,000)
Premium on bonds payable	Level 2—adjusted market value, using market-based interest rate applied to contractual cash flows	(4,000)
Warranty liability	Level 3—other estimate, discounted cash flow based on estimated future cash flows	(12,000)
Total liabilities		(141,000)
Fair value of net identifiable assets		<u>\$ 705,000</u>

Recording the Acquisition. The price paid for the company being acquired is normally measured as the sum of the consideration (total assets) exchanged for the business. This would be the sum of the cash, other assets, debt securities issued, and any stock issued by the acquiring company. In a rare case, the fair value of the company being purchased may be more determinable than the consideration given. This could be the case where stock is issued that is not publicly traded and the fair value of the business acquired is more measurable. The basic procedures to record the purchase are as follows:

- ◆ All accounts identified are measured at estimated fair value as demonstrated above. This is true even if the consideration given for a company is less than the sum of the fair values of the net assets (assets minus liabilities assumed, \$705,000 in the above example).

⁵ FASB ASC 820, *Fair Value Measurement and Disclosure* (Norwalk, CT, 2010)

- ◆ If the total consideration given for a company exceeds the fair value of its net identifiable assets (\$705,000), the excess price paid is recorded as goodwill.
- ◆ In a rare case where total consideration given for a company is less than the fair value of its net identifiable assets (\$705,000), the excess of the net assets over the price paid is recorded as an ordinary gain in the period of the purchase.
- ◆ All acquisition costs are expensed in the period of the purchase. These costs could include the fees of accountants and lawyers that were necessary to negotiate and consummate the purchase. In the past, these costs were included as part of the price paid for the company purchased.

Examples of Recording an Acquisition Using Value Analysis. Prior to attempting to record a purchase, an analysis should be made comparing the price paid for the company with the fair value of the net assets acquired.

- ◆ If the price exceeds the sum of the fair value of the net identifiable assets acquired, the excess price is goodwill.
- ◆ If the price is less than the sum of the fair value of the net identifiable assets acquired, the price deficiency is a gain.

1. Price paid exceeds fair value of net identifiable assets acquired.

Acquisitions, Inc., issues 40,000 shares of its \$1 par value common stock shares with a market value of \$20 each for Johnson Company, illustrated above. Acquisitions, Inc., pays related acquisition costs of \$35,000.

Value Analysis:

Total price paid (consideration given), 40,000 shares × \$20 market value	\$ 800,000
Total fair value of net assets acquired from Johnson Company	<u>(705,000)</u>
Goodwill (excess of total cost over fair value of net assets)	<u>\$ 95,000</u>
Expense acquisition costs	<u>\$ 35,000</u>

CENGAGE **brain**

	Dr.	Cr.
To record purchase of net assets:		
Cash	40,000	
Marketable Investments	66,000	
Inventory	110,000	
Land	72,000	
Buildings	288,000	
Equipment	145,000	
Customer List	125,000	
Goodwill	95,000	
Current Liabilities		25,000
Bonds Payable		100,000
Premium on Bonds Payable		4,000
Warranty Liability		12,000
Common Stock (\$1 par, 40,000 shares issued)		40,000
Paid-In Capital in Excess of Par (\$20 per share × 40,000 shares less \$40,000 assigned to par)		760,000
<i>Dr. = Cr. Check Totals</i>	941,000	941,000
To record acquisition costs:		
Acquisition Expense	35,000	
Cash		35,000

2. Price paid is less than fair value of net identifiable assets acquired.

Acquisitions, Inc., issues 25,000 shares of its \$1 par value common stock with a market value of \$20 each for Johnson Company, illustrated above. Acquisitions, Inc., pays related acquisition costs of \$35,000.

Value Analysis:

Total price paid (consideration given), 25,000 shares × \$20 market value	\$ 500,000
Total fair value of net assets acquired from Johnson Company	<u>(705,000)</u>
Gain on purchase of business (excess of fair value of net assets over total cost)	<u>\$ (205,000)</u>
Expense acquisition costs	\$ 35,000

Entries to record the purchase and related costs are as follows:

	Dr.	Cr.
To record purchase of net assets:		
Cash	40,000	
Marketable Investments	66,000	
Inventory	110,000	
Land	72,000	
Buildings	288,000	
Equipment	145,000	
Customer List	125,000	
Current Liabilities		25,000
Bonds Payable		100,000
Premium on Bonds Payable		4,000
Warranty Liability		12,000
Common Stock (\$1 par, 25,000 shares issued)		25,000
Paid-In Capital in Excess of Par (\$20 per share × 25,000 shares less \$25,000 assigned to par)		475,000
Gain on Acquisition of Business		205,000
<i>Dr. = Cr. Check Totals</i>	846,000	846,000
To record acquisition costs:		
Acquisition Expense	35,000	
Cash		35,000

The gain must be reported as a separate line item in the income statement of the acquirer in the period of the acquisition. Notes must include an explanation of the reasons that allowed the gain to exist.

Recording Changes in Value During Measurement Period

During the measurement period, values assigned to accounts recorded as a part of the acquisition may be adjusted to better reflect the value of the accounts as of the acquisition date. It is possible that new assets and liabilities that existed on the acquisition date may become known during the measurement period; they must also be recorded as part of the adjustment. Changes in value caused by events that occur after the acquisition date are not part of this adjustment. They would usually be adjusted to income in the period in which they occur.

The values recorded on the acquisition date are considered “provisional.” They must be used in financial statements with dates prior to the end of the measurement period. The measurement period ends when the improved information is available or it is obvious that no better information is available. In no case can the measurement period exceed one year from the acquisition date.

Let us return to the earlier example of the acquisition of Johnson Company in exchange for stock with a total value of \$800,000. Assume now that the values assigned to the buildings, customer list, and warranty liability are provisional. The 2017 financial year will include the income statement

accounts for the acquired, Johnson Company, starting as of the October 1 acquisition date. The values and resulting adjustments to income for 2017 and projected for 2018 are as follows:

Account	Provisional Value	Depreciation/Amortization Method	Recorded in 2017 (3 months)	Projected for 2018 (full year)
Buildings	\$288,000	20-year straight-line with \$48,000 residual value. $\$240,000/20 \text{ years} = \$12,000 \text{ per year}, \$1,000 \text{ per month}$	\$3,000	\$12,000
Customer List	125,000	5-year amortization, calculated monthly. $\$125,000/5 \text{ years} = \$25,000 \text{ per year}, \frac{1}{4} \text{ annual amount for 2017}$	6,250	25,000
Warranty Liability	(12,000)	Debited as repairs are made	3,500	7,000

Better estimates of values for these accounts become available in early 2018. The new values and revised depreciation/amortization are as follows:

Account	Revised Value	Depreciation/Amortization Method	Adjusted Amount for 2017	Amount to Be Recorded in 2018
Buildings	\$320,000	20-year straight-line with \$50,000 residual value. $\$270,000/20 \text{ years} = \$13,500 \text{ per year}, \$1,125 \text{ per month}$	\$3,375	\$13,500
Customer List	150,000	5-year amortization, calculated monthly. $\$150,000/5 \text{ years} = \$30,000 \text{ per year}, \$2,500 \text{ per month}$	7,500	30,000
Warranty Liability	(18,000)	Debited as repairs are made	3,500	10,000

The recorded values are adjusted during 2018 as follows:

	Dr.	Cr.
Buildings (\$320,000 new estimate – \$288,000 provisional value)	32,000	
Customer List (\$150,000 new estimate – \$125,000 provisional value)	25,000	
Warranty Liability (\$18,000 new estimate – \$12,000 provisional value)		6,000
Goodwill (sum of above adjustments)		51,000

Goodwill would normally absorb the impact of the adjustments to all other accounts since it is the difference between the price paid and the values assigned to identifiable net assets. Had there been a gain on the original acquisition date, the gain would be adjusted at the end of the measurement period. Since the gain was recorded in the prior period, the entry to adjust the amount of the gain would be made to retained earnings. If there is goodwill but the increase in net assets is greater than the amount of goodwill, a gain would be recorded for the balance of the adjustment.

The depreciation/amortizations for the prior period must also be adjusted retroactively. The entry made in 2018 would be as follows:

	Dr.	Cr.
Retained Earnings (net adjustment of $\$375 + \$1,250$)	1,625	
Accumulated Depreciation—Buildings		375
Customer List		1,250

The comparative statements, which include 2017, would include the revised amounts. The revised depreciation and amortization amounts (\$13,500 and \$30,000, respectively, for 2018) would be recorded in 2018.

Recording Contingent Consideration

Let us again revisit the acquisition of Johnson Company. This time, we will assume that the acquirer issued 40,000 shares of stock with a market value of \$800,000. In addition to the stock issue, the acquirer agreed to pay an additional \$100,000 on January 1, 2020, if the average income during the 2-year period of 2018–2019 exceeds \$80,000 per year. The expected value is calculated as \$40,000 based on the 40% probability of exceeding an average income of \$80,000 and having to pay the added \$100,000. The revised value analysis and recording of the acquisition would be as follows:

Value Analysis:

Total price paid:

Stock issued, 40,000 shares × \$20 market value	\$800,000	
Estimated value of contingent payment	40,000	\$ 840,000
Total fair value of net assets acquired from Johnson Company		(705,000)
Goodwill		\$ 135,000
Expense acquisition costs		\$ 35,000

Entries to record acquisition and related costs are as follows:

	Dr.	Cr.
To record purchase of net assets:		
Cash	40,000	
Marketable Investments	66,000	
Inventory	110,000	
Land	72,000	
Buildings	288,000	
Equipment	145,000	
Customer List	125,000	
Goodwill	135,000	
Current Liabilities		25,000
Bonds Payable		100,000
Premium on Bonds Payable		4,000
Warranty Liability		12,000
Estimated Liability for Contingent Consideration		40,000
Common Stock (\$1 par, 40,000 shares issued)		40,000
Paid-In Capital in Excess of Par (\$20 per share × 40,000 shares less \$40,000 assigned to par)		760,000
Dr. = Cr. Check Totals	981,000	981,000
To record acquisition costs:		
Acquisition Expense	35,000	
Cash		35,000

If during the measurement period, the contingent consideration was revalued based on improved information, the estimated liability and the goodwill (or gain in a bargain acquisition) would be adjusted. For example, assume that within the measurement period the estimate was revised to \$50,000, the adjustment would then be as follows:

Goodwill (\$50,000 new estimate – \$40,000 provisional value)	10,000	
Estimated Liability for Contingent Consideration		10,000

If the estimate is again revised after the measurement period, the adjustment is included in the income of the later period. If the estimate was revised to \$65,000 after the measurement period, the following adjustment would be recorded:

Expense, Increase in Estimated Contingent Consideration Payment	15,000	
Estimated Liability for Contingent Consideration		15,000

The above procedure applies to any contingent payment payable in a form other than issuing additional shares of stock. An agreement to issue added stock upon the occurrence of a future event is considered to be a change in the estimate of the value of the shares issued. No liability is recorded at the acquisition date. The only entry made is at the date of the added stock issue. The procedure on that date is to reassign the original consideration assigned to the stock to a greater number of shares.

Returning to the example of the acquisition of Johnson Company for \$800,000 in stock, assume that there was an agreement to issue 5,000 additional shares if the average income during the 2-year period of 2018–2019 exceeded \$80,000 per year. There would be no change in the entry made at the top of page 17 to record the acquisition on October 1, 2017. Prior to the termination of the contingency, it would be described in a footnote.

Assuming the contingent event occurs, the following entry would be made after December 31, 2019, to reassign the \$800,000 original consideration to 45,000 total shares:

Paid-In Capital in Excess of Par (5,000 shares × \$1)	5,000	
Common Stock (\$1 par, 5,000 shares issued)		5,000

Accounting for the Acquisition by the Acquiree

The goodwill recorded by the acquirer is not tied to the gain (or loss) recorded by the acquiree. The acquiree records the removal of net assets at their book values. Recall the initial example of the acquisition of Johnson Company for \$800,000 (on page 18). The excess of the price received by the seller (\$800,000) over the sum of the net asset book value of \$335,000 (\$460,000 assets – \$125,000 liabilities) is recorded as a gain on the sale. In this case, the gain is \$465,000. The entry on Johnson’s books would be as follows:

	Dr.	Cr.
Investment in Acquisitions, Inc., Stock	800,000	
Current Liabilities	25,000	
8% 5-Year Bonds Payable	100,000	
Cash		40,000
Marketable Investments		60,000
Inventory		100,000
Land		30,000
Buildings (net)		150,000
Equipment (net)		80,000
Gain on Sale of Business		465,000
Dr. = Cr. Check Totals	925,000	925,000

The only remaining asset of Johnson Company is the stock of Acquisitions, Inc. Johnson would typically distribute the stock received to its shareholders and cease operations.

REFLECTION

- The acquirer records all accounts of the acquiree company at fair value on the acquisition date, but adjustments are allowed during the measurement period.
- The acquisition cost includes the estimated expected value of contingent consideration (except for the issuance of additional acquirer shares).
- The acquiree removes the book values of the accounts transferred and records a gain or loss on the sale.

TAX ISSUES

In some acquisitions, the acquiree may have operating losses in periods prior to the acquisition. The acquirer may be able to carry these losses forward to offset its income taxes payable periods after the acquisition. This is a “deferred tax asset” to which value will be assigned. The sale of a business may be structured as either a taxable or nontaxable event, which means the seller pays taxes on any gain in a taxable exchange but defers the taxes on a gain in a nontaxable exchange. If the exchange is taxable, the acquirer records all accounts at fair value for tax purposes and gets depreciation and amortization deductions based on the fair value of the assets on the acquisition date. There may be some differences in the tax basis and recorded financial accounting amounts. If the exchange is nontaxable, the acquirer will base future amortization and depreciation on the book value of the acquiree’s accounts on the acquisition date. This leads to deferred tax assets or liabilities that need to be recorded on the acquisition date.

Tax Loss Carryovers

Tax law provides that an existing company with a tax loss may first carry the loss back to the previous two years to offset income and thus receive a refund of taxes paid in the preceding years. If the loss exceeds income available in the prior 2-year period, the loss can be carried forward up to 20 years to offset future income and, therefore, reduce the taxes that otherwise would be paid. As mentioned earlier, Congress has extended the carryback period to five years for losses incurred in 2008–2009. Our examples will use a 2-year carryback period. The acquired company may have unused tax loss carryovers that it has not been able to utilize due to an absence of sufficient income in prior years. This becomes a potential benefit for the purchasing company. Tax provisions limit the amount of the net operating loss (NOL) available to the acquiring company to discourage business combinations that are motivated primarily by tax loss carryovers. The purchaser is allowed to use the acquired company’s tax loss carryovers to offset its own income in the current and future periods (but not prior periods) subject to limitations contained in Internal Revenue Code Section 382.

The value of the expected future tax loss carryovers is recorded as a deferred tax asset (DTA) on the date of the acquisition. It is, however, necessary to attempt to determine whether there will be adequate future tax liabilities to support the value of the deferred tax asset. The accountant would have to consider existing evidence to make this determination. If it is likely that some or all of the deferred tax asset will not be realized, the contra account Allowance for Unrealizable Tax Assets would be used to reduce the deferred tax asset to an estimated amount to be realized.⁶ This may have the practical effect of the contra account totally offsetting the deferred tax asset. The inability to record a net deferred tax asset often will result in the consideration paid for the NOL carryover being assigned to goodwill. This occurs because the price paid will exceed the value of the net assets that are allowed to be recorded.

EXAMPLE

Bergen Company had the following book and fair values on the date it was acquired by Panther Company:

Account	Book Value	Fair Value
Cash	\$ 30,000	\$ 30,000
Accounts Receivable	80,000	80,000
Inventory	100,000	120,000
Land	140,000	200,000
Building (net)	250,000	465,000
Equipment (net)	50,000	75,000
Patent	0	50,000
Accounts Payable	(90,000)	(90,000)
Bonds Payable	(100,000)	(100,000)
Net Assets	<u>\$ 460,000</u>	<u>\$ 830,000</u>

⁶ FASB ASC 740-10-30-5, *Income Tax—Overall—Initial Measurement* (Norwalk, CT, 2010).

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OBJECTIVE

Demonstrate an understanding of the tax issues that arise in an acquisition.

Assume that the price paid for Bergen Company is \$1,000,000. Bergen Company has tax loss carryforwards of \$200,000.

The value of the tax loss carryforward is calculated as follows:

Losses that may be carried forward	\$200,000
Applicable tax rate	× 40%
Potential tax savings	\$ 80,000
Adjustment for amount not likely to be usable	(30,000)
Net value of tax loss carryforward	<u>\$ 50,000</u>

Value Analysis:

Total price paid:	
Stock issued, 50,000 shares × \$20 market value	\$1,000,000
Fair value of net assets acquired	(830,000)
Net value of tax loss carryforward	(50,000)
Goodwill	<u>\$ 120,000</u>

The entry to record the acquisition is as follows:

	Dr.	Cr.
To record purchase of net assets:		
Cash	30,000	
Accounts Receivable	80,000	
Inventory	120,000	
Land	200,000	
Buildings	465,000	
Equipment	75,000	
Patent	50,000	
Deferred Tax Asset	80,000	
Goodwill	120,000	
Valuation Allowance for Deferred Tax Asset		30,000
Accounts Payable		90,000
Bonds Payable		100,000
Common Stock (\$1 par, 50,000 shares issued)		50,000
Paid-In Capital in Excess of Par (\$20 per share × 50,000 shares less \$50,000 assigned to par)		950,000
<i>Dr. = Cr. Check Totals</i>	<i>1,220,000</i>	<i>1,220,000</i>

If there is a decrease in estimate for the valuation account within one year of the acquisition date, goodwill is reduced for the same amount. Thus, if within one year, the valuation account were lowered by \$20,000 (from \$30,000 to \$10,000), Goodwill would be credited for \$20,000 as follows:

Valuation Allowance for Deferred Tax Asset	20,000	
Goodwill		20,000

However, if the adjustment is caused by events that occur after the acquisition, the credit would be to the current provision for taxes.⁷ Changes in the valuation account after the 1-year period result in an adjustment to the tax provision for the period in which the new estimate is made.

⁷ FASB ASC 805-740-45-4, *Business Combinations—Income Taxes—Other Presentation Matters* (Norwalk, CT, 2010).

Tax Values in an Acquisition

There may be limitations on amounts that can be assigned to certain accounts even in a taxable exchange. For example, a fixed asset may have the following values:

Book value on the books of acquiree	\$75,000
Estimated fair value for financial accounting	90,000
Basis required at acquisition for tax purposes	50,000

This would occur when the company used straight-line depreciation for financial reporting, but used accelerated depreciation for its tax returns. The asset would still be recorded at the fair value of \$90,000, but a deferred tax liability (DTL) would be recorded for the lost tax deductibility equal to the tax rate (40%) times the excess of the fair value over tax value calculated as follows:

Fair value	\$90,000
Tax value	<u>50,000</u>
Excess not deductible	40,000
Tax rate	<u>× 40%</u>
Deferred tax liability	<u>\$16,000</u>

The DTL would be amortized over the depreciable life of the asset. Assuming a 5-year asset life and straight-line depreciation, the annual tax impact using a 40% tax rate would be \$3,200 (\$16,000/5 years), which would be recorded as follows:

Deferred Tax Liability	3,200	
Current Tax Liability		3,200

Goodwill, while not amortized for financial reporting purposes, is amortized straight-line over 15 years for tax purposes.

Nontaxable Exchange

In a nontaxable exchange, the acquirer is limited to deductions for amortization and depreciation based on the book values of the acquiree on the acquisition date. Despite this, all accounts are still recorded at full fair value, and deferred tax liability or asset accounts are recorded as follows:

Difference	Results in:
Fair value of identifiable asset exceeds book value	DTL
Book value of identifiable asset exceeds fair value	DTA
Fair value of liability exceeds book value	DTA
Book value of liability exceeds fair value	DTL

EXAMPLE

To understand the impact of a nontaxable exchange, consider an example of the acquisition of Book Company for \$1,500,000. The consideration was 50,000 shares of \$1 par value shares of the acquirer company. The market value of an acquirer share was \$30. The tax rate is 40%. Fair values are compared to the tax basis of Book Company as shown on page 26.

Column	1	2	3	4
Account	Fair Value	Tax Basis	Fair Value in Excess of Tax Basis (Col. 1. – Col. 2)	DTA (DTL) (–40% × Col. 3)
Cash	\$ 100,000	\$ 100,000	\$ 0	\$ 0
Accounts Receivable	150,000	180,000	(30,000)	12,000
Inventory	200,000	160,000	40,000	(16,000)
Land	200,000	150,000	50,000	(20,000)
Building	600,000	450,000	150,000	(60,000)
Equipment	300,000	200,000	100,000	(40,000)
Copyrights	100,000	2,000	98,000	(39,200)
Accounts Payable	(250,000)	(250,000)	0	0
Bonds Payable	(315,000)	(300,000)	(15,000)	6,000
Net Identifiable Assets	<u>\$1,085,000</u>	<u>\$ 692,000</u>	<u>\$393,000</u>	<u>\$(157,200)</u>

Value Analysis:

Total price paid:

Stock issued, 50,000 shares × \$30 market value

\$1,500,000

Fair value of net assets acquired

\$1,085,000

DTL

157,200

Net identifiable assets less net DTL

927,800

Goodwill

\$ 572,200

The entry to record the acquisition is as follows:

	Dr.	Cr.
To record purchase of net assets:		
Cash	100,000	
Accounts Receivable	150,000	
Inventory	200,000	
Land	200,000	
Buildings	600,000	
Equipment	300,000	
Copyright	100,000	
Goodwill	572,200	
DTL		157,200
Accounts Payable		250,000
Bonds Payable		300,000
Premium on Bonds Payable		15,000
Common Stock (\$1 par, 50,000 shares issued)		50,000
Paid-In Capital in Excess of Par (\$30 per share × 50,000 shares less \$50,000 assigned to par)		1,450,000
<i>Dr. = Cr. Check Totals</i>	<i>2,222,200</i>	<i>2,222,200</i>

While the DTL is recorded as a single amount, each component would be realized separately. The amount applicable to accounts payable would be realized as the accounts are collected; the amount applicable to inventory would be realized when the inventory is sold. The amounts applicable to the land would be deferred until the land is sold. All other amounts are amortized over the life of the accounts to which the DTA/DTL pertains.

R E F L E C T I O N

- The acquisition may include a tax loss carryover from the acquiree which results in the recording a deferred tax asset (DTA).
- In a taxable exchange, the values used for taxation may differ from those assigned in the acquisition. Typically, lower book values will be used for depreciation in future years. This results in a deferred tax liability (DTL).
- The acquisition may be a nontaxable exchange, which means the book values will be used for taxation and fair values will be used for financial reporting. Because book values are usually lower than fair value, this also results in a DTL.

REQUIRED DISCLOSURE

Substantial disclosure requirements for an acquisition occur during the reporting period. These requirements are detailed in FASB ASC 805-10-50-2⁸ and can be summarized as follows:

- a. The name and description of the acquiree.
- b. The acquisition date.
- c. The percentage of voting equity interest acquired.
- d. The primary reasons for the acquisition and the factors that contributed to the recording of goodwill (if any).
- e. A qualitative description of factors that make up the goodwill recognized.
- f. The acquisition date fair value of all types of consideration, including cash, other assets, contingent consideration, and debt and equity instruments issued.
- g. Detailed information concerning contingent consideration, including a description of the arrangements and the range of outcomes.
- h. Details concerning acquired receivables, including gross amount, fair value and the expected collections.
- i. Disclosure showing amounts recorded for each major class of assets and liabilities. For the acquisition of Johnson Company for \$800,000 in stock on page 18, the disclosure information would appear as follows:

Current assets	\$216,000
Property, plant, and equipment	505,000
Intangible assets subject to amortization	125,000
Intangible assets not subject to amortization	0
Goodwill	95,000
Total assets acquired	<u>\$941,000</u>
Current liabilities	\$ 37,000
Long-term debt	104,000
Total liabilities assumed	<u>\$141,000</u>
Net assets acquired	<u>\$800,000</u>

Exhibit 1-3 is an example of an actual disclosure for the acquisition of Metavante, a Milwaukee data processing company, by Fidelity National Information Services, Inc. The allocation of the price paid included intangible assets and a large amount of goodwill.

⁸ IFRS for SMEs, International Accounting Standards Board, 2009, London, Section 19.

6

OBJECTIVE

Explain the disclosure that is required in the period in which an acquisition occurs.

Exhibit 1-3

Fidelity National Information Services, Inc. and Subsidiaries
Notes to Consolidated Financial Statements**(6) Acquisitions and Dispositions**

The results of operations and financial position of the entities acquired during the years ended December 31, 2009, 2008, and 2007 are included in the Consolidated Financial Statement from and after the date of acquisition. There were no significant acquisitions in 2008.

2009 Significant Acquisition

Metavante. On October 1, 2009, we completed the acquisition of Metavante (the "Metavante Acquisition") Metavante expands the scope of FIS core processing and payment capabilities, adds trust and wealth management services and includes the NYCE Network, a leading national EFT network. In addition, Metavante adds significant scale to treasury and cash management offerings and provides an entry into the emerging markets of healthcare and government payments. Pursuant to the Agreement and Plan of Merger (the "Metavante Merger Agreement") dated as of March 31, 2009, Metavante became a wholly-owned subsidiary of FIS. Each issued and outstanding share of Metavante common stock, par value \$0.01 per share, was converted into 1.35 shares of FIS common stock. In addition, outstanding Metavante stock options and other stock-based awards converted into comparable FIS stock options and other stock-based awards at the same conversion ratio.

The total purchase price was as following (in millions):

Value of Metavante common stock	\$4,066.4
Value of Metavante stock awards	<u>121.4</u>
Total purchase price	<u>\$4,187.8</u>

We have recorded a preliminary allocation of the purchase price to Metavante tangible and identifiable intangible assets acquired and liabilities assumed based on their fair values as of October 1, 2009. Goodwill has been recorded based on the amount by which the purchase price exceeds the fair value of the net assets acquired. The preliminary purchase price allocation is as follows (in millions):

Cash	\$ 439.7
Trade and other receivables	237.9
Land, buildings, and equipment	119.8
Other assets	144.4
Computer software	287.7
Intangible assets	1,572.0
Goodwill	4,083.1
Liabilities assumed	(2,673.4)
Noncontrolling interest	<u>(23.4)</u>
Total purchase price	<u>\$ 4,187.8</u>

The preliminary allocation of the purchase price to intangible assets, including computer software and customer relationships, is based on valuations performed to determine the fair value of such assets as of the merger date. The Company is still assessing the economic characteristics of certain software projects and customer relationships. The Company expects to substantially complete this assessment during the first quarter of 2010 and may adjust the amounts recorded as of December 31, 2009 to reflect any revised evaluations. Land and building valuations are based upon appraisals performed by certified property appraisers.

- j. Information on assets and liabilities arising from contingencies.
- k. The goodwill that will be deductible for tax purposes.
- l. Goodwill assigned to reportable segments (if any).
- m. Information concerning transactions between the companies that are not recorded as part of the acquisition.
- n. Disclosure of acquisition costs and issue costs associated with the transaction. This includes identifying the line item of the income statement that includes the acquisition costs.
- o. Any gain resulting from the acquisition. The gain is to be disclosed as a separate line item on the income statement. The reasons for the gain must also be disclosed.
- p. The fair value of the noncontrolling interest and the method used to value it.
- q. The gain or loss on prior investments in a step acquisition. A step acquisition is where a controlling interest is purchased in stages (explained in Chapter 7).
- r. Publicly traded firms must disclose the following performance measures:
 1. Revenue and earnings of the acquiree since the acquisition date
 2. Pro forma revenue and earnings had the acquisition occurred at the start of the reporting period
 3. If comparative statements are issued, pro forma revenue and earnings for all prior periods for which comparative statements are issued

Exhibit 1-4 is an example of a pro forma disclosure from Merck & Co., Inc.

Exhibit 1-4 Supplemental Pro Forma Data

Schering-Plough's results of operations have been included in New Merck's financial statement for periods subsequent to the completion of the Merger. Schering-Plough contributed revenues of \$3.4 billion and estimated losses of \$2.2 billion to New Merck for the period from the consummation of the Merger through December 31, 2009. The following unaudited supplemental pro forma data presents consolidated information as if the Merger had been completed on January 1, 2008:

Years Ended December 31	2009	2008
Sales	\$45,970.7	\$46,749.6
Earnings attributable to Merck & Co., Inc.	6,069.7	3,020.4
Earnings available to Merck & Co., Inc. common shareholders	5,934.7	2,883.2
Basic earnings per common share available to common shareholders	1.91	0.92
Earning per common share assuming dilution available to common shareholders	1.90	0.92

The information included in Exhibit 1-4 is also to be included in the notes for an acquisition that occurs after the balance sheet date but prior to the issuance date of the financial statement. If the initial accounting for the acquisition is incomplete, those disclosures that could not be made and why they could not be made must be stated.

REFLECTION

- There are detailed disclosure requirements for the period in which an acquisition occurs.
- Disclosure includes pro forma amounts for revenue and earnings for the entire period and for prior periods shown in comparative statements.

7

OBJECTIVE

Apply the impairment test to goodwill and adjust goodwill when needed.

GOODWILL IMPAIRMENT

Goodwill is no longer amortized for financial reporting purposes. It was amortized for up to 40 years for financial reporting prior to the issuance of FASB Statement No. 142, *Goodwill and Other Intangible Assets*, in 2001, and it still is amortized over 15 years for tax purposes. Since the issuance of FASB Statement No. 142, goodwill is now subject to *impairment testing*. Impairment testing is a procedure for testing and estimating goodwill at the end of each financial reporting period.

Five specific concerns need to be addressed to apply impairment testing:

1. Goodwill must be allocated to reporting units if the acquired company contains more than one reporting unit.
2. Methods for valuing the reporting unit must be established.
3. Impairment testing is normally done on an annual basis. There are, however, exceptions to annual testing and some cases where testing may be required between annual testing dates.
4. The procedure for determining if impairment has occurred must be established.
5. The procedure for determining the amount of the impairment loss, which is also the decrease in the goodwill amount recorded, must be established.

Allocating Goodwill to Reporting Units

In most cases, the company acquired will be made up of more than one reporting unit. For purposes of segment reporting, under FASB ASC 280-10-50-1,⁹ a reporting unit is either the same level or one level lower than an operating segment. To be a reporting unit that is one level below an operating unit, both of the following criteria must be met:

- ◆ Segment managers measure and review performance at this level.
- ◆ The unit has separate financial information available and has economic characteristics that distinguish it from other units of the operating segment.

All assets and liabilities are to be allocated to the underlying reporting units. Goodwill is allocated to the reporting segments by subtracting the identifiable net assets of the unit from the estimated fair value of the entire reporting unit. The method of estimating the fair value of the reporting unit should be documented. In essence, an estimate must be made of the price that would have been paid for only the specific reporting unit.

Reporting Unit Valuation Procedures

The steps in the reporting unit measurement process will be illustrated with the following example of the acquisition of Lakeland Company, which is a purchase of a single operating unit.

- A. Determine the valuation method and estimated fair value of the identifiable assets, goodwill, and all liabilities of the reporting unit.

At the time of acquisition, the valuations of Lakeland Company's identifiable assets, liabilities, and goodwill were as shown on page 31. [The asterisk (*) indicates numbers have been rounded for presentation purposes.]

⁹ FASB ASC 280-10-50-1, *Segment Reporting—Overall—Disclosure* (Norwalk, CT, 2010).

Assets	Comments	Valuation Method	Fair Value
Inventory available	Replacement cost	Market replacement cost for similar items	\$ 45,000
Accounts receivable	Recorded amount is adjusted for estimated bad debts	Aging schedule used for valuation	28,000
Land	Per-acre value well established	Five acres at \$10,000 per acre	50,000
Building	Most reliable measure is rent potential	Rent estimated at \$20,000 per year for 20 years, discounted at 14% return for similar properties; present value of \$132,463 reduced for \$50,000 land value	80,000*
Equipment	Cost of replacement capacity can be estimated	Estimated purchase cost of equipment with similar capacity	50,000
Patent	Recorded by seller at only legal cost; has significant future value	Added profit made possible by patent is \$11,600 per year for four years; discounted at risk adjusted rate for similar investments of 20% per year; PV equals \$30,029	30,000*
Brand-name copyright	Not recorded by seller	Estimated sales value	40,000
Current liabilities	Recorded amounts are accurate	Recorded value	(5,000)
Bonds payable	Specified interest rate is above market rate	Discount at market interest rate	(21,000)
Net identifiable assets at fair value			\$297,000
Price paid for reporting unit			360,000
Goodwill	Believed to exist based on projected future cash flows	Implied by price paid	\$ 63,000

*Rounded to nearest thousands to reflect nature of estimate.

B. Measure the fair value of the reporting unit and document assumptions and models used to make the measurement. This measurement is made to:

- ◆ Serve as a test for the amount of goodwill recorded for the reporting unit.
- ◆ Establish the procedure to be used to value the reporting unit in later periods.

If the stock of the reporting unit is publicly traded, the market capitalization of the reporting unit may be indicative of its fair value, but it need not be the only measure considered. The price paid to acquire all of the shares or a controlling interest could exceed the product of the fair value per share times the number of shares outstanding. A common method used to estimate fair value is to determine the present value of the unit's future cash flows. The following is an example of that approach.

Assumptions:

1. The reporting unit will provide operating cash flows, net of tax, of \$40,000 during the next reporting period.
2. Operating cash flows will increase at the rate of 10% per year for the next four reporting periods and then will remain steady for 15 more years.
3. Forecast cash flows will be adjusted for capital expenditures needed to maintain market position and productive capacity.
4. Cash flows defined as net of cash from operations less capital expenditures will be discounted at an after-tax discount rate of 12%. An annual rate of 12% is a reasonable risk-adjusted rate of return for investments of this type.
5. An estimate of salvage value (net of tax effect of gains or losses) of the assets at the end of 20 years will be used to approximate salvage value. This is a conservative assumption, since the unit may be operated after that period.

Schedule of net tax cash flows:

Year	Net of Tax Operating Flow*	Capital Expenditure	Salvage Value	Net Cash Flow
1	\$40,000			\$ 40,000
2	44,000			44,000
3	48,400			48,400
4	53,240			53,240
5	58,564	\$(25,000)		33,564
6	58,564			58,564
7	58,564			58,564
8	58,564			58,564
9	58,564			58,564
10	58,564	(30,000)		28,564
11	58,564			58,564
12	58,564			58,564
13	58,564			58,564
14	58,564			58,564
15	58,564	(35,000)		23,564
16	58,564			58,564
17	58,564			58,564
18	58,564			58,564
19	58,564			58,564
20	58,564		\$75,000	133,564
Net present value at 12% annual rate				\$376,173

*Reflects assumed 10% annual increase in years 2–5.

C. Compare fair value of reporting unit with amounts assigned to identifiable net assets plus goodwill.

Estimated fair value of reporting unit	\$376,173
Price paid for reporting unit	360,000
Excess of fair value of reporting unit over net assets	<u>\$16,173</u>

An excess of the fair value of the reporting unit over the value of the net assets indicated that the price paid was reasonable and below a theoretical maximum purchase price. It requires no adjustment of assigned values. If, however, the fair value of the net assets, including goodwill, exceeds the fair value of the reporting unit, the model used to determine the fair value of the reporting unit should be reassessed. If the re-estimation of the values assigned to the net assets, including goodwill, and the reporting unit still indicates an excess of the value of the net assets, including goodwill, over the value of the reporting unit, goodwill is to be tested for impairment. This would likely result in an impairment loss being recorded on the goodwill at the time of the acquisition.

Frequency of Impairment Testing

The normal procedure is to perform impairment testing of goodwill on an annual basis. Testing need not be done at period-end; it can be done on a consistent, scheduled, annual basis during the reporting period.

The annual impairment test is not needed if *all* the following criteria are met:

- ◆ The assets and liabilities of the unit have not significantly changed since the last valuation;
- ◆ The last calculation of the unit's fair value far exceeded book value, thus making it unlikely that the unit's fair value could now be less than book value; and
- ◆ No adverse events indicating that the fair value of the unit has fallen below book value have occurred since the last valuation.

There may also be instances when goodwill must be impairment tested sooner than the normal annual measurement date. These situations include the occurrence of an adverse event that could diminish the unit's fair value, the likelihood that the unit will be disposed of, the impairment of a group of the unit's assets (under FASB Statement No. 121), or a goodwill impairment loss that is recorded in a higher-level organization of which the unit is a part.

Impairment Testing in Later Periods

Goodwill is considered to be impaired if the implied fair value of the reporting unit is less than the carrying value of the reporting unit's net assets (including goodwill). Remember, since the acquired net assets were recorded at their fair values as of the acquisition date, it is the subsequent carrying (book) value based on those amounts that is used for later periods of impairment testing.

Let us revisit the Lakeland Company example. Assume that the following new estimates were made at the end of the first year:

Estimated implied fair value of the reporting unit, based on analysis of projected cash flow (discounted at 12% annual rate)	\$320,000
Existing net book value (including values assigned on acquisition date) of the reporting unit (including goodwill)	345,000

Since the recorded net book value of the reporting unit exceeds its implied fair value, goodwill is considered to be impaired. If the estimated fair value exceeds the existing book value, there is no impairment, and there is no need to proceed to calculate a goodwill impairment loss.

Goodwill Impairment Loss in Later Periods

If the above test indicates impairment, the impairment loss must be estimated. **The impairment loss for goodwill is the excess of the implied fair value of the reporting unit over the fair value of the reporting unit's identifiable net assets (excluding goodwill) on the impairment date.** These are the values that would be assigned to those accounts if the reporting unit were purchased on the date of impairment measurement.

For our example, the following calculation was made for the impairment loss:

Estimated implied fair value of reporting unit, based on cash flow analysis (discounted at a 12% annual rate)	\$320,000
Less: Fair value of net assets on the date of measurement, exclusive of goodwill	285,000
Implied fair value of goodwill	\$ 35,000
Existing recorded goodwill	63,000
Estimated impairment loss	<u>\$ (28,000)</u>

The following journal entry would be made:

Goodwill Impairment Loss	28,000	
Goodwill		28,000

The impairment loss will be shown as a separate line item within the operating section unless it is identified with a discontinued operation, in which case, it is part of the gain or loss on disposal. **Once goodwill is written down, it cannot be adjusted to a higher amount.**

Two important issues must be understood at this point.

1. The **impairment test** compares the implied fair value of the reporting unit, \$320,000, to the unit's **book value (including goodwill), \$345,000**. The **impairment loss calculation** compares the implied fair value of the reporting unit, \$320,000, to the unit's **estimated fair values (excluding goodwill), \$285,000**, on the impairment date.

2. While fair values of net assets are used to measure the impairment loss, they are not recorded. The existing book values on the impairment date remain in place (unless they are adjusted for their own impairment loss).

Significant disclosure requirements for goodwill exist in any period in which goodwill changes. A note must accompany the balance sheet in any period that has a change in goodwill. The note would explain the goodwill acquired, the goodwill impairment losses, and the goodwill written off as part of a disposal of a reporting unit. It is further required that information be included that provides the details of any impairment loss recorded during the period. The information would include the reporting unit involved, the circumstances leading to the impairment, and the possibility of further adjustments.

R E F L E C T I O N

- Procedures must be established for estimating goodwill.
- Goodwill is subject to impairment testing.
- When impaired, the goodwill is reduced to a lower estimated value.

8

O B J E C T I V E

Explain special and different rules that apply to acquisitions by companies that are not publicly traded.

SPECIAL METHODS FOR SMALLER COMPANIES

In July 2009, the International Accounting Standards Board (IASB) issued special standards designed for use by small and medium-sized entities (SMEs).¹⁰ The AICPA Governing Board recognizes the IASB as an accounting standards-setting body. This allows CPAs to report using financial accounting standards in conformity with International Financial Reporting Standards, which includes IFRS for SMEs. The use of these standards is really not based on size; rather, it is based on the source of the company's equity and debt financing. The standards are available for companies that issue financial statements to external users but do not have publicly traded bonds or stock. External users would include bank regulatory agencies.

Acquisition Costs and Assigning Value

SMEs do not expense acquisition-related costs. Instead, SMEs include these costs in the purchase cost for the entity acquired. There is no difference in accounting for the costs of issuing securities used as consideration. They are deducted from the value assigned to the securities issued.

There are some differences concerning contingent liabilities, employee benefit plans, and deferred taxes. The major difference is that **goodwill is amortized** instead of being subject to impairment adjustment. If the company cannot make a reliable estimate of the amortization period, the life is presumed to be 10 years.

R E F L E C T I O N

- SMEs may use special standards available to them under IFRS. The major difference in this chapter is that acquisition costs are expensed and goodwill is amortized.

¹⁰ IFRS for SMEs, International Accounting Standards Board, 2009, London, Section 19.

APPENDIX: ESTIMATING THE VALUE OF GOODWILL

9

OBJECTIVE

Estimate the value of goodwill.

An acquirer may attempt to forecast the future income of a target company in order to arrive at a logical purchase price. Goodwill is often, at least in part, a payment for above-normal expected future earnings. A forecast of future income may start by projecting recent years' incomes into the future. When this is done, it is important to factor out "one-time" occurrences that will not likely recur in the near future. Examples would include extraordinary items, discontinued operations, or any other unusual event. Expected future income is compared to "normal" income. Normal income is the product of the appropriate industry rate of return on assets times the fair value of the gross assets (no deduction for liabilities) of the acquired company. Gross assets include specifically identifiable intangible assets such as patents and copyrights but do not include existing goodwill. The following calculation of earnings in excess of normal might be made for the Johnson Company example on page 16:

Expected average future income	\$100,000
Less normal return on assets:	
Fair value of total identifiable assets	\$846,000
Industry normal rate of return	× 10%
Normal return on assets	84,600
Expected annual earnings in excess of normal	<u>\$ 15,400</u>

Several methods use the expected annual earnings in excess of normal to estimate goodwill. A common approach is to pay for a given number of years of excess earnings. For instance, Acquisitions, Inc., might offer to pay for four years of excess earnings, which would total \$61,600 (\$15,400 × 4 years). Alternatively, the excess earnings could be viewed as an annuity. The most optimistic purchaser might expect the excess earnings to continue forever. If so, the buyer might capitalize the excess earnings as a perpetuity at the normal industry rate of return according to the following formula:

$$\begin{aligned}
 \text{Goodwill} &= \frac{\text{Annual Excess Earnings}}{\text{Industry Normal Rate of Return}} \\
 &= \frac{\$15,400}{0.10} \\
 &= \$154,000
 \end{aligned}$$

Another estimation method views the factors that produce excess earnings to be of limited duration, such as 10 years, for example. This purchaser would calculate goodwill as follows:

$$\begin{aligned}
 \text{Goodwill} &= \text{Discounted present value of a \$15,400-per-year annuity for 10 years at 10\%} \\
 &= \$15,400 \times 10\text{-year, 10\% present value of annuity factor} \\
 &= \$15,400 \times 6.1446 \\
 &= \$94,627
 \end{aligned}$$

Other analysts view the normal industry earning rate to be appropriate only for identifiable assets and not goodwill. Thus, they might capitalize excess earnings at a higher rate of return to reflect the higher risk inherent in goodwill.

All calculations of goodwill are only estimates used to assist in the determination of the price to be paid for a company. For example, Acquisitions might add the \$94,627 estimate of goodwill to the \$705,000 fair value of Johnson's other net assets to arrive at a tentative maximum price of \$799,627. However, estimates of goodwill may differ from actual negotiated goodwill. If the final agreed-upon price for Johnson's net assets was \$790,000, the actual negotiated goodwill would be \$85,000, which is the price paid less the fair value of the net assets acquired.

R E F L E C T I O N

- Goodwill estimates are based on an estimate of predicted income in excess of normal.
- Predicted excess income is typically discounted either as perpetuity or as a limited term annuity.

UNDERSTANDING THE ISSUES

1. Identify each of the following business combinations as being vertical-backward, vertical-forward, horizontal, product extension, market extension, or conglomerate:
 - a. An inboard marine engine manufacturer is acquired by an outboard engine manufacturer.
 - b. A cosmetics manufacturer acquires a drug store chain.
 - c. A financial holding company acquires a mail order movie rental company.
 - d. A computer manufacturer acquires a chip manufacturer.
 - e. The Walt Disney Company acquires a broadcasting company.
 - f. A California-based electric utility acquires a Colorado electric utility company.
2. Abrams Company is a sole proprietorship. The book value of its identifiable net assets is \$400,000, and the fair value of the same net assets is \$600,000. It is agreed that the business is worth \$850,000. What advantage might there be for the seller if the company is exchanged for the common stock of another corporation as opposed to receiving cash? Consider both the immediate and future impact.
3. Major Corporation is acquiring Abrams Company by issuing its common stock in a nontaxable exchange. Major is issuing common stock with a fair value of \$850,000 for net identifiable assets with book and fair values of \$400,000 and \$600,000, respectively. What values will Major assign to the identifiable assets, to goodwill, and to the deferred tax liability? Assume a 40% tax rate.
4. Panther Company is about to acquire a 100% interest in Snake Company. Snake has identifiable net assets with book and fair values of \$300,000 and \$500,000, respectively. As payment, Panther will issue common stock with a fair value of \$750,000. How would the transaction be recorded if the acquisition is:
 - a. An acquisition of net assets?
 - b. An acquisition of Snake’s common stock and Snake remains a separate legal entity?
5. Puncho Company is acquiring the net assets of Semos Company in exchange for common stock valued at \$900,000. The Semos identifiable net assets have book and fair values of \$400,000 and \$800,000, respectively. Compare accounting for the acquisition (including assignment of the price paid) by Puncho with accounting for the sale by Semos.
6. Panther Company is acquiring the net assets of Sharon Company. The book and fair values of Sharon’s accounts are as follows:

Accounts	Book	Fair
Current Assets	\$100,000	\$120,000
Land	50,000	80,000
Building and Equipment	300,000	400,000
Customer List	0	20,000
Liabilities	100,000	100,000

What values will be assigned to current assets, land, building and equipment, the customer list, liabilities, goodwill, and gain under each of the following acquisition price scenarios?

- a. \$800,000
- b. \$450,000

7. Pam Company acquires the net assets of Jam Company for an agreed-upon price of \$900,000 on July 1, 2011. The value is tentatively assigned as follows:

Current assets	\$ 100,000
Land	50,000
Equipment	200,000 (5-year life)
Building	500,000 (20-year life)
Current liabilities	(150,000)
Goodwill	200,000

Values are subject to change during the measurement period. Depreciation is taken to the nearest month. The measurement period expires on July 1, 2012, at which time the fair values of the equipment and building as of the acquisition date are revised to \$180,000 and \$550,000, respectively.

At the end of 2012, what adjustments are needed for the financial statements for the period ending December 31, 2011 and 2012?

8. Harms acquires Blake on January 1, 2011, for \$1,000,000. The amount of \$800,000 is assigned to identifiable net assets. Goodwill is being impairment tested on December 31, 2015. There have not been any prior impairment adjustments. The following values apply on that date:

Estimated fair value of the Blake operating unit	\$1,200,000
Fair value of net identifiable assets (excluding goodwill)	1,120,000
Book value of net identifiable assets (including goodwill)	1,250,000

The book values include those resulting from assignment of fair value to accounts included in the January 1, 2011, acquisition.

Is goodwill impaired? If it is, what is the amount of the impairment adjustment?

9. What are the accounting ramifications of each of the three following situations involving the payment of contingent consideration in an acquisition?
- a. P Company issues 100,000 shares of its \$50 fair value (\$1 par) common stock as payment to buy S Company on January 1, 2011. P agrees to pay \$100,000 cash two years later if S income exceeds an income target. The target is exceeded.
 - b. P Company issues 100,000 shares of its \$50 fair value (\$1 par) common stock as payment to buy S Company on January 1, 2011. P agrees to issue 10,000 additional shares of its stock two years later if S income exceeds an income target. The target is exceeded.
 - c. P Company issues 100,000 shares of its \$50 fair value (\$1 par) common stock as payment to buy S Company on January 1, 2011. P agrees to issue 5,000 additional shares two years later if the fair value of P shares falls below \$50 per share. Two years later, the stock has a fair value below \$50, and added shares are issued to S.
10. P Company acquired the S Company for an agreed value of \$900,000 and issues its common stock to make the deal. The fair value of the Company S net identifiable assets is \$800,000. The issue costs of the stock used for payment is \$50,000. If P Company was eligible to use IFRS for SME's and decided to do so, how would the recording of the transaction differ from U.S. GAAP?

EXERCISES

Exercise 1 (LO 2, 3, 4) Asset versus stock acquisition. Barton Company is contemplating the acquisition of the net assets of Crowley Company for \$850,000 cash. To complete the transaction, acquisition costs are \$15,000. The balance sheet of Crowley Company on the purchase date is as follows:

Crowley Company Balance Sheet December 31, 2011			
Assets		Liabilities and Equity	
Current assets	\$ 80,000	Liabilities	\$100,000
Land	50,000	Common stock (\$10 par) . . .	100,000
Building	450,000	Paid-in capital in excess of par	150,000
Accumulated depreciation—building . .	(200,000)	Retained earnings	<u>230,000</u>
Equipment	300,000		
Accumulated depreciation—equipment .	<u>(100,000)</u>		
Total assets	<u>\$ 580,000</u>	Total liabilities and equity .	<u>\$580,000</u>

The following fair values have been obtained for Crowley's identifiable assets and liabilities:

Current assets	\$100,000
Land	90,000
Building	300,000
Equipment	275,000
Liabilities	102,000

1. Record the acquisition of the net assets of Crowley Company on Barton Company's books.
2. Record the sale of the net assets on the books of Crowley Company.
3. Record the acquisition of 100% of the common stock of Crowley Company on Barton's books. Crowley Company will remain a separate legal entity.



Exercise 2 (LO 3, 4) Bargain acquisition. Norton Corporation agrees to acquire the net assets of Payco Corporation. Just prior to the acquisition, Payco's balance sheet is as follows:

Payco Corporation
Balance Sheet
January 1, 2011

Assets		Liabilities and Equity	
Accounts receivable	\$200,000	Current liabilities	\$ 80,000
Inventory	270,000	Mortgage payable	<u>250,000</u> \$330,000
Equipment (net)	<u>100,000</u>	Stockholders' equity:	
		Common stock (\$10 par)	\$100,000
		Retained earnings	<u>140,000</u> <u>240,000</u>
Total assets	<u>\$570,000</u>	Total liabilities and equity	<u>\$570,000</u>

Fair values agree with book values except for the equipment, which has an estimated fair value of \$40,000. Also, it has been determined that brand-name copyrights have an estimated value of \$15,000. Norton Corporation pays \$25,000 in acquisition costs to consummate the transaction.

Record the acquisition on the books of Norton Corporation assuming the cash paid to Payco Corporation is \$160,000.

Suggestion: Use value analysis to guide your calculations and entries.

Exercise 3 (LO 3, 4) Acquisition with goodwill. Smyth Company is acquired by Radar Corporation on July 1, 2011. Radar exchanges 60,000 shares of its \$5 par stock, with a fair value of \$20 per share, for the net assets of Smyth Company.

Radar incurs the following costs as a result of this transaction:

Acquisition costs	\$25,000
Stock registration and issuance costs.	10,000
Total costs	<u>\$35,000</u>

The balance sheet of Smyth Company, on the day of the acquisition, is as follows:

Smyth Company
Balance Sheet
July 1, 2011

Assets		Liabilities and Equity	
Cash	\$ 100,000	Current liabilities	\$ 80,000
Inventory	300,000	Bonds payable	<u>550,000</u>
Property, plant, and equipment:		Stockholders' equity:	
Land	\$200,000	Common stock	\$200,000
Buildings (net)	250,000	Paid-in capital in excess of par ...	100,000
Equipment (net)	<u>200,000</u>	Retained earnings	<u>120,000</u>
Total assets	<u>\$1,050,000</u>	Total liabilities and equity	<u>\$1,050,000</u>

The appraised fair values as of July 1, 2011, is as follows:

Inventory	\$250,000
Equipment	220,000
Land	180,000
Buildings	300,000
Current liabilities	80,000
Bonds payable	410,000

Record the acquisition of Smyth Company on the books of Radar Corporation.

Exercise 4 (LO 3, 4) Acquisition with special valuations. Pederson Company acquires the net assets of Shelby Company by issuing 100,000 of its \$1 par value shares of common stock. The shares have a fair value of \$20 each. Just prior to the acquisition, Shelby's balance sheet is as follows:

Shelby Company
Balance Sheet
January 1, 2011

Assets		Liabilities and Equity	
Accounts receivable	\$100,000	Current liabilities	\$ 80,000
Inventory	210,000	Bonds payable	<u>200,000</u>
Equipment (net)	100,000	Stockholders' equity:	
Land	200,000	Common stock (\$1 par)	\$ 10,000
Building (net)	<u>300,000</u>	Retained earnings	<u>620,000</u>
Total assets	<u>\$910,000</u>	Total liabilities and equity	<u>\$910,000</u>

Fair values agree with book values except for the building, which is appraised at \$450,000. The following additional information is available:

- ◆ The equipment will be sold for an estimated price of \$200,000. A 10% commission will be paid to a broker.
- ◆ A major R&D project is underway. The accumulated costs are \$56,000, and the estimated value of the work is \$90,000.

- ◆ A warranty attaches to products sold in the past. The estimated future repair costs under the warranty are \$40,000.
- ◆ Shelby has a customer list that has value. It is estimated that the list will provide additional income of \$100,000 for three years. An intangible asset such as this is valued at a 20% rate of return.

Record the acquisition of Shelby Company on the books of Pederson Company. Provide calculations where needed.

Exercise 5 (LO 4) Contingent consideration. Gull Company purchased the net assets of Hart Company on January 1, 2011, and made the following entry to record the purchase:

Current Assets	100,000	
Equipment	150,000	
Land	50,000	
Buildings	300,000	
Goodwill	100,000	
Liabilities		80,000
Common Stock (\$1 par)		100,000
Paid-In Capital in Excess of Par		520,000

Make the required entry on January 1, 2013, for each of the following independent contingency agreements:

1. An additional cash payment will be made on January 1, 2013, equal to twice the amount by which average annual earnings of the Hart Division exceed \$25,000 per year, prior to January 1, 2013. Net income was \$50,000 in 2011 and \$60,000 in 2012. Assume that the liabilities recorded on January 1, 2011, included an estimated contingent liability recorded at an estimated amount of \$40,000.
2. Added shares will be issued on January 1, 2013, equal in value to twice the amount by which average annual earnings of the Hart Division exceed \$25,000 per year, prior to January 1, 2013. Net income was \$50,000 in 2011 and \$60,000 in 2012. The market price of the shares on January 1, 2013, will be \$5.
3. Added shares will be issued on January 1, 2013, to compensate for any fall in the value of Gull common stock below \$6 per share. The settlement will cure the deficiency by issuing added shares based on their fair value on January 1, 2013. The market price of the shares on January 1, 2013, will be \$4.

Exercise 6 (LO 4) Measurement period. Avery Company acquires the net assets of Iowa Company on July 1, 2011. The net assets acquired include plant assets that are provisionally estimated to have a fair value of \$600,000 with a 10-year usable life and no salvage value. Depreciation is recorded based on months in service. The remaining unallocated amount of the price paid is \$300,000, which is recorded as goodwill.

At the end of 2011, Avery prepares the following statements (includes Iowa Company for the last six months):

Balance Sheet			
Current assets	\$ 300,000	Current liabilities	\$ 300,000
Equipment (net)	600,000	Bonds payable	500,000
Plant assets (net)	1,600,000	Common stock (\$1 par)	50,000
Goodwill	300,000	Paid-in capital in excess of par ...	1,300,000
		Retained earnings	650,000
Total assets	<u>\$2,800,000</u>	Total liabilities and equity	<u>\$2,800,000</u>

Summary Income Statement

Sales revenue		\$800,000
Cost of goods sold		<u>520,000</u>
Gross profit		\$280,000
Operating expenses	\$150,000	
Depreciation expense	<u>80,000</u>	<u>230,000</u>
Net income		<u>\$ 50,000</u>

In March 2012, the final estimated fair value of the acquired plant assets is \$700,000 with no change in the estimate of useful life or salvage value.

1. Prepare any journal entries required in March 2012.
2. Prepare the revised balance sheet and income statement for 2011 that will be included in the 2012 comparative statements.

Exercise 7 (LO 5) Deferred tax liability. Your client, Lewison International, has informed you that it has reached an agreement with Herro Company to acquire all of Herro's assets. This transaction will be accomplished through the issue of Lewison's common stock.

After your examination of the financial statements and the acquisition agreement, you have discovered the following important facts.

The Lewison common stock issued has a fair value of \$800,000. The fair value of Herro's assets, net of all liabilities, is \$700,000. All asset book values equal their fair values except for one machine valued at \$200,000. This machine was originally purchased two years ago by Herro for \$180,000. This machine has been depreciated using the straight-line method with an assumed useful life of 10 years and no salvage value. The acquisition is to be considered a tax-free exchange for tax purposes.

Assuming a 30% tax rate, what amounts will be recorded for the machine, deferred tax liability, and goodwill?

Exercise 8 (LO 5) Tax loss carryover. Lakecraft Company has the following balance sheet on December 31, 2011, when it is acquired for \$950,000 in cash by Argo Corporation:



Lakecraft Company
Balance Sheet
December 31, 2011

Assets		Liabilities and Equity	
Current assets	\$100,000	Current liabilities	\$ 60,000
Equipment (net)	200,000	Stockholders' equity:	
Building (net)	270,000	Common stock (\$5 par)	\$100,000
		Retained earnings	<u>410,000</u>
			510,000
Total assets	<u>\$570,000</u>	Total liabilities and equity	<u>\$570,000</u>

All assets have fair values equal to their book values. The combination is structured as a tax-free exchange. Lakecraft Company has a tax loss carryforward of \$300,000, which it has not recorded. The balance of the \$300,000 tax loss carryover is considered fully realizable. Argo is taxed at a rate of 30%.

Record the acquisition of Lakecraft Company by Argo Corporation.

Exercise 9 (LO 7) Goodwill impairment. Anton Company acquired the net assets of Hair Company on January 1, 2011, for \$600,000. Using a business valuation model, the estimated value of Anton Company was \$650,000 immediately after the acquisition. The fair value of Anton's net assets was \$400,000.

1. What amount of goodwill was recorded by Anton Company when it acquired Hair Company?

2. Using the information on page 41, answer the questions posed in the following two independent situations:
 - a. On December 31, 2012, there were indications that goodwill might have been impaired. At that time, the existing recorded book value of Anton Company's net assets, including goodwill, was \$500,000. The fair value of the net assets, exclusive of goodwill, was estimated to be \$340,000. The value of the business was estimated to be \$520,000. Is goodwill impaired? If so, what adjustment is needed?
 - b. On December 31, 2014, there were indications that goodwill might have been impaired. At that time, the existing recorded book value of Anton Company's net assets, including goodwill, was \$450,000. The fair value of the net assets, exclusive of goodwill, was estimated to be \$340,000. The value of the business was estimated to be \$400,000. Is goodwill impaired? If so, what adjustment is needed?

APPENDIX EXERCISE



Exercise 1A-1 (LO 9) Estimating goodwill. Green Company is considering acquiring the assets of Gold Corporation by assuming Gold's liabilities and by making a cash payment. Gold Corporation has the following balance sheet on the date negotiations occur:

Gold Corporation
Balance Sheet
January 1, 2016

Assets		Liabilities and Equity	
Accounts receivable	\$100,000	Total liabilities	\$200,000
Inventory	100,000	Capital stock (\$10 par)	100,000
Land	100,000	Paid-in capital in excess of par	200,000
Building (net)	220,000	Retained earnings	300,000
Equipment (net)	280,000		
Total assets	<u>\$800,000</u>	Total liabilities and equity	<u>\$800,000</u>

Appraisals indicate that the inventory is undervalued by \$25,000, the building is undervalued by \$80,000, and the equipment is overstated by \$30,000. Past earnings have been considered above average and were as follows:

Year	Net Income
2011	\$ 90,000
2012	110,000
2013	120,000
2014	140,000*
2015	130,000

*Includes a nonrecurring gain of \$40,000.

It is assumed that the average operating income of the past five years will continue. In this industry, the average return on assets is 12% on the fair value of the total identifiable assets.

1. Prepare an estimate of goodwill based on each of the following assumptions:
 - a. The purchasing company paid for five years of excess earnings.
 - b. Excess earnings will continue indefinitely and are to be capitalized at the industry normal return.
 - c. Excess earnings will continue for only five years and should be capitalized at a higher rate of 16%, which reflects the risk applicable to goodwill.
2. Determine the actual goodwill recorded if Green pays \$690,000 cash for the net assets of Gold Corporation and assumes all existing liabilities.

PROBLEMS

Problem 1-1 (LO 3) Purchase of two companies with goodwill. Bar Corporation has been looking to expand its operations and has decided to acquire the assets of Vicker Company and Kendal Company. Bar will issue 30,000 shares of its \$10 par common stock to acquire the net assets of Vicker Company and will issue 15,000 shares to acquire the net assets of Kendal Company.



Vicker and Kendal have the following balance sheets as of December 31, 2011:

Assets	Vicker	Kendal
Accounts receivable	\$ 200,000	\$ 80,000
Inventory	150,000	85,000
Property, plant, and equipment:		
Land	150,000	50,000
Buildings	500,000	300,000
Accumulated depreciation	(150,000)	(110,000)
Total assets	<u>\$ 850,000</u>	<u>\$ 405,000</u>
Liabilities and Equity		
Current liabilities	\$160,000	\$ 55,000
Bonds payable	100,000	100,000
Stockholders' equity:		
Common stock (\$10 par)	300,000	100,000
Retained earnings	<u>290,000</u>	<u>150,000</u>
Total liabilities and equity	<u>\$850,000</u>	<u>\$405,000</u>

The following fair values are agreed upon by the firms:

Assets	Vicker	Kendal
Inventory	\$190,000	\$100,000
Land	300,000	80,000
Buildings	450,000	400,000
Bonds payable	90,000	95,000

Bar's stock is currently trading at \$40 per share. Bar will incur \$5,000 of acquisition costs in acquiring Vicker and \$4,000 of acquisition costs in acquiring Kendal. Bar will also incur \$15,000 of registration and issuance costs for the shares issued in both acquisitions.

Bar's stockholders' equity is as follows:

Common stock (\$10 par)	\$1,200,000
Paid-in capital in excess of par	800,000
Retained earnings	750,000

Record the acquisitions on the books of Bar Corporation. Value analysis is suggested to guide your work. **Required**

Problem 1-2 (LO 3, 4) Value analysis, alternative prices. Brass Corporation agrees to acquire the net assets of Warn Corporation on January 1, 2011. Warn has the following balance sheet on the date of acquisition:



Warn Corporation
Balance Sheet
January 1, 2011

Assets		Liabilities and Equity	
Accounts receivable	\$ 79,000	Current liabilities	\$145,000
Inventory	112,000	Bonds payable	100,000
Other current assets	55,000	Common stock	200,000
Equipment (net)	294,000	Paid-in capital in excess of par ...	50,000
Trademark	30,000	Retained earnings	75,000
Total assets	<u>\$570,000</u>	Total liabilities and equity	<u>\$570,000</u>

An appraiser determines that in-process R&D exists and has an estimated value of \$14,000. The appraisal indicates that the following assets have fair values that differ from their book values:

	Fair Value
Inventory	\$120,000
Equipment	340,000
Trademark	30,000

Required ▶▶▶▶▶ Use value analysis to prepare the entry on the books of Brass Corporation to acquire the net assets of Warn Corporation under each of the following purchase price scenarios:

1. Purchase price is \$550,000.
2. Purchase price is \$350,000.



Problem 1-3 (LO 3, 4) Alternate consideration, bargain. Kiln Corporation is considering the acquisition of Williams Incorporated. Kiln has asked you, its accountant, to evaluate the various offers it might make to Williams Incorporated. The December 31, 2011, balance sheet of Williams is as follows:

Williams Incorporated
Balance Sheet
December 31, 2011

Assets		Liabilities and Equity	
Current assets:		Accounts payable	\$ 40,000
Accounts receivable	\$ 50,000		
Inventory	<u>300,000</u>		
	\$350,000	Stockholders' equity:	
Noncurrent assets:		Common stock	\$ 40,000
Land	\$ 20,000	Paid-in capital in excess of par ...	110,000
Building (net)	<u>70,000</u>	Retained earnings	<u>250,000</u>
	90,000		400,000
Total assets	<u>\$440,000</u>	Total liabilities and equity	<u>\$440,000</u>

The following fair values differ from existing book values:

Inventory	\$250,000
Land	40,000
Building	120,000

Record the acquisition entry for Kiln Corporation that would result under each of the alternative offers. Value analysis is suggested.

◀ ◀ ◀ ◀ ◀ Required

1. Kiln Corporation issues 20,000 of its \$10 par common stock with a fair value of \$25 per share for the net assets of Williams Incorporated.
2. Kiln Corporation pays \$385,000 in cash.

Problem 1-4 (LO 3, 4) Revaluation of assets. Jack Company is a corporation that was organized on July 1, 2011. The June 30, 2016, balance sheet for Jack is as follows:



Assets		
Investments		\$ 400,500
Accounts receivable	\$1,250,000	
Allowance for doubtful accounts	(300,000)	950,000
Inventory		1,500,000
Prepaid insurance		18,000
Land		58,000
Machinery and equipment (net)		1,473,500
Goodwill		100,000
Total assets		<u>\$4,500,000</u>
Liabilities and Equity		
Current liabilities		\$1,475,000
Common stock (\$10 par)		1,200,000
Retained earnings		1,825,000
Total liabilities and equity		<u>\$4,500,000</u>

The experience of other companies over the last several years indicates that the machinery and equipment can be sold at 130% of its book value.

An analysis of the accounts receivable indicates that the realizable value is \$925,000. An independent appraisal made in June 2016 values the land at \$70,000. Using the lower-of-cost-or-market rule, inventory is to be restated at \$1,200,000.

Calway Corporation plans to exchange 18,000 of its shares for the 120,000 Jack shares. During June 2016, the fair value of a share of Calway Corporation is \$270. Acquisition costs are \$12,000.

The stockholders' equity account balances of Calway Corporation as of June 30, 2011, are as follows:

Common stock (\$10 par)	\$2,000,000
Paid-in capital in excess of par	580,000
Retained earnings	2,496,400
Total stockholders' equity	<u>\$5,076,400</u>

Record the acquisition of Jack Company by Calway on July 1, 2016. Use value analysis to support the acquisition entries.

◀ ◀ ◀ ◀ ◀ Required

Problem 1-5 (LO 3, 4) Cash purchase with goodwill. Tweeden Corporation is contemplating the acquisition of the net assets of Sylvester Corporation in anticipation of expanding its operations. The balance sheet of Sylvester Corporation on December 31, 2011, is as follows:



Sylvester Corporation
Balance Sheet
December 31, 2011

Current assets:			Current liabilities:		
Notes receivable	\$ 24,000		Accounts payable	\$ 45,000	
Accounts receivable	56,000		Payroll and benefit-related liabilities	12,500	
Inventory	31,000				
Other current assets	18,000		Debt maturing in one year	10,000	
Total current assets		\$129,000	Total current liabilities		\$ 67,500
Investments		65,000			
Fixed assets:			Other liabilities:		
Land	\$ 32,000		Long-term debt	\$248,000	
Building	245,000		Payroll and benefit-related liabilities	156,000	
Equipment	387,000				
Total fixed assets		664,000	Total other liabilities		404,000
Intangibles:			Stockholders' equity:		
Goodwill	\$ 45,000		Common stock	\$100,000	
Patents	23,000		Paid-in capital in excess of par	250,000	
Trade names	10,000		Retained earnings	114,500	
Total intangibles		78,000	Total equity		464,500
Total assets		<u>\$936,000</u>	Total liabilities and equity		<u>\$936,000</u>

An appraiser for Tweeden determined the fair values of Sylvester's assets and liabilities to be as shown below.

Assets		Liabilities	
Notes receivable	\$ 24,000	Accounts payable	\$ 45,000
Accounts receivable	56,000	Payroll and benefit-related liabilities—current	12,500
Inventory	30,000	Debt maturing in one year	10,000
Other current assets	15,000		
Investments	63,000	Long-term debt	248,000
Land	55,000	Payroll and benefit-related liabilities—long-term	156,000
Building	275,000		
Equipment	426,000		
Goodwill	—		
Patents	20,000		
Trade names	15,000		

The agreed-upon purchase price is \$580,000 in cash. Acquisition costs paid in cash total \$20,000.

Required ▶ ▶ ▶ ▶ ▶

Using the above information, do value analysis and prepare the entry on the books of Tweeden Corporation to acquire the net assets of Sylvester Corporation on December 31, 2011.



Problem 1-6 (LO 3, 4) Acquisition with contingent consideration. Hite Corporation is contemplating the acquisition of Smith Company's net assets on December 31, 2011. It is considering making an offer, which would include a cash payout of \$200,000 along with giving 15,000 shares of its \$2 par value common stock that is currently selling for \$20 per share. Hite also agrees that it will pay an additional \$50,000 on January 1, 2014, if the average net income of Smith's business unit exceeds \$80,000 for 2012 and 2013. The likelihood of reaching that target is estimated to be 75%. The balance sheet of Smith Company is given below, along with estimated fair values of the net assets to be acquired.

Smith Company
Balance Sheet
December 31, 2011

	Book Value	Fair Value		Book Value	Fair Value
Current assets:			Current liabilities:		
Notes receivable	\$ 33,000	\$ 33,000	Accounts payable	\$ 63,000	\$ 63,000
Inventory	89,000	80,000	Taxes payable	15,000	15,000
Prepaid expenses	15,000	15,000	Interest payable	3,000	3,000
Total current assets	<u>\$137,000</u>	<u>\$128,000</u>	Total current liabilities	<u>\$ 81,000</u>	<u>\$ 81,000</u>
Investments	<u>\$ 36,000</u>	<u>\$ 55,000</u>			
Fixed assets:			Other liabilities:		
Land	\$ 15,000	\$ 90,000	Bonds payable	\$250,000	\$250,000
Buildings	115,000	170,000	Discount on bonds payable	<u>(18,000)</u>	<u>(30,000)</u>
Equipment	256,000	250,000			
Vehicles	32,000	25,000	Total other liabilities	<u>\$232,000</u>	<u>\$220,000</u>
Total fixed assets	<u>\$418,000</u>	<u>\$535,000</u>			
Intangibles:			Stockholders' equity:		
Franchise	<u>\$ 56,000</u>	<u>\$ 70,000</u>	Common stock	\$ 50,000	
			Paid-in capital in excess of par	200,000	
			Retained earnings	<u>84,000</u>	
			Total equity	<u>\$334,000</u>	
Total assets	<u><u>\$647,000</u></u>	<u><u>\$788,000</u></u>	Total liabilities and equity	<u><u>\$647,000</u></u>	

1. Do value analysis and prepare the entry on the books of Hite Corporation to record the acquisition of Smith Company. ◀ ◀ ◀ ◀ ◀ Required
2. Assume that the net income of the Smith business unit is \$120,000 for 2012. As a result, the likelihood of paying the contingent consideration is believed to be 90%. What, if any, adjusting entry is required as of December 31, 2012?

Problem 1-7 (LO 3, 4) Cash acquisition with a gain. Heinrich Company, owned by Ellenor and Al Heinrich, has been experiencing financial difficulty for the past several years. Both Ellenor and Al have not been in good health and have decided to find a buyer. P&F International, after reviewing the financial statements for the previous three years, has decided to make an offer of \$150,000 for the net assets of Heinrich Company on January 1, 2012. The balance sheet as of this date is as follows:



Heinrich Company
Balance Sheet
January 1, 2012

Current assets:		Current liabilities:	
Accounts receivable	\$ 87,000	Accounts payable	\$ 56,000
Inventory	36,000	Accrued liabilities	14,000
Other current assets	14,000		
Total current assets	<u>\$137,000</u>	Total current liabilities	<u>\$ 70,000</u>
Fixed assets:		Other liabilities:	
Equipment	\$105,000	Notes payable	\$ 30,000
Vehicles	69,000		
Total fixed assets	<u>\$174,000</u>	Total liabilities	<u>\$100,000</u>

Intangibles:

Mailing lists	\$ 4,000
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Total assets	<u>\$315,000</u>
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Stockholders' equity:

Common stock	\$ 60,000
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Paid-in capital in excess of par	100,000
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Retained earnings	55,000
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Total equity	<u>\$215,000</u>
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Total liabilities and equity	<u>\$315,000</u>
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In reviewing the above balance sheet, P&F's appraiser felt the liabilities were stated at their fair values. He placed the following fair values on the assets of the company.

Heinrich Company
Fair Values
January 1, 2012

Current assets:

Accounts receivable	\$ 90,000
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Inventory	30,000
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Other current assets	8,000
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Total current assets	<u>\$128,000</u>
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Fixed assets:

Equipment	\$ 80,000
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Vehicles	50,000
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Total fixed assets	<u>\$130,000</u>
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Intangibles:

Mailing list	\$ 10,000
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Total assets	<u>\$268,000</u>
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Required ▶▶▶▶▶

Using this information, do value analysis, and prepare the entry to record the acquisition of the net assets of Heinrich Company on the books of P&F International.



Problem 1-8 (LO 3, 4, 6) Pro forma income after an acquisition. Moon Company is contemplating the acquisition of Yount, Inc., on January 1, 2011. If Moon acquires Yount, it will pay \$730,000 in cash to Yount and acquisition costs of \$20,000.

The January 1, 2011, balance sheet of Yount, Inc., is anticipated to be as follows:

Yount, Inc.
Pro Forma Balance Sheet
January 1, 2011

Assets		Liabilities and Equity	
Cash equivalents	\$100,000	Current liabilities	\$ 30,000
Accounts receivable	120,000	Long-term liabilities	165,000
Inventory	50,000	Common stock (\$10 par)	80,000
Depreciable fixed assets	200,000	Retained earnings	115,000
Accumulated depreciation	(80,000)		
Total assets	<u>\$390,000</u>	Total liabilities and equity	<u>\$390,000</u>

Fair values agree with book values except for the inventory and the depreciable fixed assets, which have fair values of \$70,000 and \$400,000, respectively.

Your projections of the combined operations for 2011 are as follows:

Combined sales	\$200,000
Combined cost of goods sold, including Yount's beginning inventory, at book value, which will be sold in 2011	120,000
Other expenses not including depreciation of Yount assets	25,000
Depreciation on Yount fixed assets is straight-line using a 20-year life with no salvage value.	

1. Prepare a value analysis for the acquisition and record the acquisition.
2. Prepare a pro forma income statement for the combined firm for 2011. Show supporting calculations for consolidated income. Ignore tax issues.

◀ ◀ ◀ ◀ ◀ Required

Problem 1-9 (LO 3, 4, 6) Issue stock, goodwill, pro forma disclosure.



Part A. Garman International wants to expand its operations and decides to acquire the net assets of Iris Company as of January 1, 2012. Garman issues 10,000 shares of its \$5 par value common stock for the net assets of Iris. Garman's stock is selling for \$27 per share. In addition, Garman pays \$10,000 in acquisition costs. A balance sheet for Iris Company as of December 31, 2011, is as follows:

Current assets:

Accounts receivable	\$ 15,000
Inventory	38,000
Prepaid expenses	12,000
Total current assets	\$ 65,000
Investments	19,000

Fixed assets:

Land	\$30,000
Building	70,000
Equipment	56,000
Total fixed assets	156,000

Intangibles:

Patent	\$17,000
Copyrights	22,000
Goodwill	8,000
Total intangibles	47,000
Total assets	\$287,000

Current liabilities:

Accounts payable	\$ 22,000
Interest payable	2,000
Total current liabilities	\$ 24,000

Other liabilities:

Long-term notes payable	40,000
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Total liabilities	\$ 64,000
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Stockholders' equity:

Common stock	\$ 40,000
Paid-in capital in excess of par	120,000
Retained earnings	63,000
Total equity	223,000
Total liabilities and equity	\$287,000

In reviewing Iris's balance sheet and in consulting with various appraisers, Garman has determined that the inventory is understated by \$2,000, the land is understated by \$10,000, the building is understated by \$15,000, and the copyrights are understated by \$4,000. Garman has also determined that the equipment is overstated by \$6,000, and the patent is overstated by \$5,000.

The investments have a fair value of \$33,000 on December 31, 2011, and the amount of goodwill (if any) must be determined.

Part A. Using the information above, do value analysis, and record the acquisition of Iris Company on Garman International's books on January 1, 2012.

◀ ◀ ◀ ◀ ◀ Required

Part B. Garman International wishes to estimate its pro forma disclosure of operations for 2012 resulting from acquisition of Iris. Pro forma disclosure includes revenue and net income. Projected income statements for 2012 are as follows:

Income Statement Accounts	Garman International	Iris Company
Sales Revenue	\$(350,000)	\$(125,000)
Cost of Goods Sold	147,000	55,000
Gross Profit	\$(203,000)	\$ (70,000)
Selling Expenses*	\$ 100,000	\$ 20,000
Administrative Expenses*	50,000	30,000
Depreciation Expense	12,500	8,600
Amortization Expense	1,000	3,900
Total Operating Expenses	\$ 163,500	\$ 62,500
Operating Income	\$ (39,500)	\$ (7,500)
Nonoperating Revenues and Expenses:		
Interest Expense		3,000
Investment Income	(12,000)	(4,500)
Income Before Taxes	\$ (51,500)	\$ (9,000)
Provision for Income Taxes (40% rate)	20,600	3,600
Net Income	<u>\$ (30,900)</u>	<u>\$ (5,400)</u>

*Does not include depreciation or amortization expense.

Garman International estimates that the following amount of depreciation and amortization should be taken on the revalued assets of Iris Company:

Building depreciation	\$4,000
Equipment depreciation	5,000
Patent amortization	1,200
Copyright amortization	2,600

Required ▶▶▶▶▶

Part B. Using the above information, prepare a pro forma income statement for Garman International combined with Iris Company for the year ended December 31, 2012. Schedule your calculations for revenue and net income.

Problem 1-10 (LO 3, 4) Revaluation of leases Sentry, Inc., acquires for \$2,300,000 in cash, the net assets of New Equipment Company. The acquisition is made on December 31, 2011, at which time New Equipment has prepared the following balance sheet:

New Equipment Company
Balance Sheet
December 31, 2011

Assets		Liabilities and Equity	
Current assets	\$ 100,000	Current liabilities	\$ 150,000
Assets under operating leases	520,000	Obligation under capital lease of equipment	35,000
Net investment in direct financing (capital leases)	730,000	Common stock (\$5 par)	100,000
		Paid-in capital in excess of par	400,000
Leased equipment under capital lease (net)	40,000	Retained earnings	955,000
Buildings (net)	200,000		
Land	50,000		
Total assets	<u>\$1,640,000</u>	Total liabilities and equity	<u>\$1,640,000</u>

The following information is available concerning the assets and liabilities of New Equipment:

- Current assets and liabilities are stated fairly. No payments resulting from leases are included in current accounts, since all payments are due each December 31 and payment for 2011 has been made.

- b. Assets under operating leases have an estimated value of \$580,000. This figure includes consideration of remaining rents and the value of the assets at the end of the lease terms.
- c. The net investment in direct financing leases represents receivables at their discounted present values. All leases except one are based on the current market interest rate of 12%. One equipment lease is included at an amount of \$199,636. This lease includes five and of the year payments of \$50,000 present valued at an 8% interest rate. This lease should be adjusted to its real fair value using a 12% annual interest rate.
- d. The buildings and land have appraised fair values of \$400,000 and \$100,000, respectively.
- e. The leased equipment under the capital lease pertains to a computer used by New Equipment. The obligation under the capital lease of equipment includes the present value of five remaining payments of \$9,233 due at the end of each year and discounted at 10%. Title transfers to the lessee at the end of the lease term. The current interest rate for this type of transaction is 12%. The fair value of the equipment under the lease is \$60,000.
- f. New Equipment has expended \$100,000 on R&D leading to new equipment applications. Sentry estimates the value of this work to be \$200,000.
- g. New Equipment has been named in a \$200,000 lawsuit involving an accident by a lessee using its equipment. It is likely that New Equipment will be found liable in the amount of \$50,000.

Record the acquisition of New Equipment Company by Sentry, Inc. Carefully support your entry. You may assume that the price will allow goodwill to be recorded. ◀ ◀ ◀ ◀ ◀ **Required**

Problem 1-11 (LO 5) Tax-free exchange, tax loss carryover. Hanson Company issues 10,000 shares of \$10 par common stock for the net assets of Marcus Incorporated on December 31, 2012. The stock has a fair value of \$65 per share. Acquisition costs are \$10,000, and the cost of issuing the stock is \$3,000. At the time of the purchase, Marcus had the following summarized balance sheet:

Assets		Liabilities and Equity	
Current assets	\$150,000	Bonds payable	\$200,000
Equipment (net)	200,000	Common stock (\$10 par)	100,000
Land and buildings (net)	250,000	Retained earnings	300,000
Total assets	<u>\$600,000</u>	Total liabilities and equity	<u>\$600,000</u>

The only fair value differing from book value is equipment, which is worth \$350,000. Marcus has \$180,000 in operating losses in prior years. The previous asset values are also the tax basis of the assets, which will be the tax basis for Hanson, since the acquisition is a tax-free exchange. Hanson is confident that it will recover the entire tax loss carryforward applicable to the past losses of Marcus. The applicable tax rate is 30%.

Record the acquisition of the net assets of Marcus Incorporated by Hanson Company. You may assume the price paid will allow goodwill to be recorded. Use value analysis to support your solution. ◀ ◀ ◀ ◀ ◀ **Required**

Problem 1-12 (LO 6) Income statements after acquisition. On July 1, 2011, Faber Enterprises acquired Ann's Tool Company. Prior to the merger of the two companies, each company calculated its income for the entire year ended December 31, 2011. (It may be assumed that all Ann amounts occurred evenly over the year.) These estimates are as follows:



Income Statement Accounts	Faber Enterprises	Ann's Tool Company
Sales Revenue	\$550,000	\$140,000
Cost of Goods Sold	<u>200,000</u>	<u>50,000</u>
Gross Profit	\$350,000	\$ 90,000
Selling Expenses	\$125,000	\$30,000
Administrative Expenses	150,000	45,000
Depreciation Expense	13,800	7,500
Amortization Expense	<u>5,600</u>	<u>2,000</u>
Total Operating Expenses	<u>294,400</u>	<u>84,500</u>

Operating Income	\$ 55,600	\$ 5,500
Nonoperating Revenues and Expenses:		
Interest Expense		4,000
Interest Income	7,000	
Dividend Income	4,000	
Income Before Taxes	\$ 66,600	\$ 1,500
Provision for Income Taxes (30% rate) . . .	19,980	450
Net Income	<u>\$ 46,620</u>	<u>\$ 1,050</u>

An analysis of the merger agreement revealed that the purchase price exceeded the fair value of all assets by \$40,000. The book and fair values of Ann's Tool Company on July 1, 2011, are given in the table below along with an estimate of the useful lives of each of these asset categories.

Asset Account	Book Value	Fair Value	Useful Life
Inventory	\$30,000	\$ 28,000	Sold August 2011
Land	50,000	80,000	Unlimited
Buildings	75,000	125,000	25 years
Equipment	32,000	56,000	8 years
Truck	1,000	3,000	2 years
Patent	12,000	18,000	6 years
Computer Software	0	10,000	2 years
Copyright	0	20,000	10 years

Management believes the company will be in a combined tax bracket of 30%. The company uses the straight-line method of computing depreciation and amortization and assigns a zero salvage value.

Required ▶▶▶▶▶

- Using the above information, prepare the Faber Enterprises income statement for the year ending December 31, 2011. Provide supporting calculations.
- Prepare the required summarized disclosure of 2011 results if the acquisition occurs at the start of the year.



Problem 1-13 (LO 4, 6) Contingent consideration. Door Corporation acquires the net assets, exclusive of cash, of Walsh Company on January 1, 2011, at which time Walsh Company's balance sheet is as follows:

Assets			
Current assets:			
Cash	\$ 30,000		
Accounts receivable	50,000	\$ 80,000	
Noncurrent assets:			
Investments in marketable securities	\$120,000		
Land	600,000		
Buildings (net)	450,000		
Equipment (net)	800,000		
Goodwill	100,000	2,070,000	
Total assets		<u>\$2,150,000</u>	
Liabilities and Stockholders' Equity			
Current liabilities:			
Accounts payable	\$ 150,000		
Income tax payable	190,000	\$ 340,000	
Equity:			
Common stock (\$5 par)	\$1,200,000		
Retained earnings	610,000	1,810,000	
Total liabilities and equity		<u>\$2,150,000</u>	

Door Corporation feels that the following fair values should be used for Walsh's book values:

Cash (no change)	\$ 30,000
Accounts receivable	60,000
Investment in marketable securities	150,000
Land	450,000
Buildings (no change)	450,000
Equipment	600,000
Accounts payable	120,000
Income tax payable (no change)	190,000

Door issues 20,000 shares of its common stock with a \$2 par value and a quoted fair value of \$60 per share on January 1, 2011, to Walsh Company to acquire the net assets. Door also agrees that two years from now it will issue additional securities to compensate Walsh shareholders for any decline in value below that on the date of issue.

1. Record the acquisition on the books of Door Corporation on January 1, 2011. Include support for calculations used to arrive at the values assigned to the assets and liabilities. Use value analysis to aid your solution. ◀ ◀ ◀ ◀ ◀ Required
2. Record payment (if any) of contingent consideration on January 1, 2013, assuming that the quoted value of the stock is \$57.50. (Round shares to nearest whole share.)

APPENDIX PROBLEM

Problem 1A-1 (LO 9) Estimate goodwill, record acquisition. Caswell Company is contemplating the purchase of LaBelle Company as of January 1, 2016. LaBelle Company has provided the following current balance sheet:

Assets		Liabilities and Equity	
Cash and receivables	\$ 150,000	Current liabilities	\$ 120,000
Inventory	180,000	9% Bonds payable	300,000
Land	50,000	Common stock (\$5 par)	100,000
Building	600,000	Paid-in capital in excess of par	200,000
Accumulated depreciation	(150,000)	Retained earnings	150,000
Goodwill	40,000		
Total assets	<u>\$ 870,000</u>	Total liabilities and equity	<u>\$870,000</u>

The following information exists relative to balance sheet accounts:

- a. The inventory has a fair value of \$200,000.
- b. The land is appraised at \$100,000 and the building at \$600,000.
- c. The 9% bonds payable have five years to maturity and pay annual interest each December 31. The current interest rate for similar bonds is 8% per year.
- d. It is likely that there will be a payment for goodwill based on projected income in excess of the industry average, which is 10% on total assets. Caswell will project the average past five years' operating income and will pay for excess income based on an assumption of a 5-year life and a risk rate of return of 16%. The past five years' net incomes for LaBelle are as follows:

2011	\$120,000
2012	140,000
2013	150,000
2014	200,000 (includes \$40,000 extraordinary gain)
2015	180,000

1. Provide an estimate of fair value for the bonds and for goodwill. ◀ ◀ ◀ ◀ ◀ Required
2. Using the values derived in part (1), record the acquisition on the Caswell books.