DEBRA C. JETER • PAUL K. CHANEY

ADVANCED ACCOUNTING

Seventh Edition

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DEBRA C. JETER

PAUL K. CHANEY

WILEY

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PREFACE

This book is designed for advanced courses dealing with financial accounting and reporting in the following topical areas: business combinations, consolidated financial statements, international accounting, foreign currency transactions, accounting for derivative instruments, translation of financial statements of foreign affiliates, segment reporting and interim reporting, partnerships, fund accounting and accounting for governmental units, and accounting for nongovernment—nonbusiness organizations. The primary objective of this book is to provide a comprehensive treatment of selected topics in a clear and understandable manner. The changes related to FASB ASC Topics 805 and 810 (SFAS No. 141R and 160) are integrated throughout the edition. As in previous editions, we strive to maintain maximum flexibility to the instructor in the selection and breadth of coverage for topics dealing with consolidated financial statements and other advanced topics.

We track the number and characteristics of mergers and acquisitions through various eras and allow this information to influence our coverage in the textbook. For instance, the frequency of acquisitions with earnouts and with noncontrolling interests is approximately equal (each around 10% of acquisitions). Therefore, we have increased the number of examples and homework where contingent consideration is included. In addition, because of the increase in cross-border acquisitions, we address the issue of consolidating multinational firms and of reporting performance over time when exchange rates change. We have added a section in Chapter 13 on non-GAAP constant currency reporting.

One of the challenges of this revision relates to situations in which FASB spreads the effective implementation of a change in standard over several years, with early adoption allowed. Thus, financial statements that will be observed over the next few years may reflect the new standards or the prior standards. We have chosen to report the newest standard changes in the textbook (supplemented either by discussions of the prior rules or through the use of an appendix illustrating the former standards).

We expanded the number and variety of exercises and problem materials at the end of each chapter. In addition, we include financial statement analysis exercises that relate to real companies and practical applications in every chapter. Two appendices (Appendix ASC at the back of the book and Appendix A to Chapter 1) are presented to assist the student in solving these exercises. All chapters have been updated to reflect the most recent pronouncements of the Financial Accounting Standards Board and the Governmental Accounting Standards Board as of this writing. We include codification exercises that require the student to research the FASB's Codification to determine the appropriate GAAP for a variety of issues.

In teaching consolidation concepts, a decision must be made about the recording method that should be emphasized in presenting consolidated workpaper procedures. The three major alternatives for recording investments in subsidiaries are the (1) cost method, (2) partial equity (or simple equity) method, and (3) complete equity (or sophisticated equity) method. A brief description of each method follows.

1. *Cost method*. The investment in subsidiary is carried at its cost, with no adjustments made to the investment account for subsidiary income or dividends. Dividends received by the parent company are recorded as an increase in cash and as dividend income.

2. *Partial equity method*. The investment account is adjusted for the parent company's share of the subsidiary's reported earnings or losses, and dividends received from the subsidiary are deducted from the investment account. Generally, no other adjustments are made to the investment in subsidiary account.
3. *Complete equity method*. This method is the same as the partial equity method except that additional adjustments are made to the investment in subsidiary account to reflect the effects of (a) the elimination of unrealized intercompany profits, (b) the amortization (depreciation) of the difference between cost and book value, and (c) the additional stockholders' equity transactions undertaken by the subsidiary that change the parent company's share of the subsidiary's stockholders' equity.

All three are acceptable under both U.S. GAAP and IFRS, so long as the appropriate consolidating entries are made. While the FASB appears to prefer the complete equity method, the IASB, on the other hand, seems to prefer the cost method. We continue to present all three methods, using generic icons to distinguish among the three methods. The instructor has the flexibility to teach all three methods, or to instruct the students to ignore one or two. If the student is interested in learning all three methods, he or she can do so, even if the instructor only focuses on one or two. In addition, we believe this feature makes the book an excellent reference for the student to keep after graduation, so that he or she can easily adapt to any method needed in future practice.

WHAT'S NEW IN THE TEXT?

- We have updated the online videos explaining some of the critical concepts from each chapter and walk students through how to solve selected problems throughout the book.
- The partnership chapters have been updated to comply with FASB's position regarding when goodwill should (and should not) be recorded in business transactions/combinations. However, since many partnerships are not required to comply with GAAP and are thus allowed greater flexibility with respect to goodwill, we continue to present the traditional goodwill method for accounting for changes in partnership composition; we clarify which approaches are (are not) GAAP compliant.
- The coverage of certain topics has been expanded (such as contingent consideration and bargain purchases) to incorporate information gleaned from the FASB's Post-Implementation Review of FASB Statement No. 141R and to include more realistic real-world issues.
- Chapter 11 on International Accounting has been completely rewritten to focus on International Financial Reporting Standards (IFRS). In addition, in Section 11.5, we have written a stand-alone section on accounting for mergers and acquisitions using IFRS that can be used with the material in Chapters 4 or 5 to embrace an international focus on cross-border mergers and acquisitions if desired.
- Chapter 19 was revised to incorporate FASB's new not-for-profit standards on the reporting of net assets and other significant changes to the not-for-profit model.
- Chapter 2 was reorganized for improved flow of topics. It has been updated for the new goodwill impairment standards and other changes in the standards (measurement period adjustments and contingent consideration).
- We continue to provide real-world examples and use these to motivate coverage in the textbook. For instance, in Chapter 13, we have added a discussion of non-GAAP disclosures on constant currency amounts.
- To conserve space, two chapters (Chapters 9 and 10) and some topics within chapters are now located online (see www.wiley.com/go/jeter/AdvancedAccounting7e; see table of contents for more details).
- A continuous consolidation problem is introduced in Chapters 4 and 5. This allows students to build on concepts learned in prior chapters.

OTHER HIGHLIGHTED FEATURES OF THE TEXT

1. For all mergers and acquisition problems involving workpapers, we provide printable excel templates that can be used to reduce student time required in solving the problems.
2. We include a discussion of international accounting standards on each topic where such standards exist and compare and contrast U.S. GAAP and IFRS. An IFRS icon appears in the margins where this discussion occurs.
3. We have written Chapter 11 to highlight IFRS. We have added new analyzing financial statement problems; each highlights a specific difference in accounting between U.S. GAAP and IFRS. Also in this chapter, Section 11.5 on accounting for mergers and acquisitions using IFRS was written so that it can be used

as a stand-alone section and/or incorporated into the mergers and acquisition Chapters 4 or 5. Thus, if a professor would like to cover global mergers and acquisition, this can easily be accomplished.

4. FASB's conceptual framework is discussed as it relates to Advanced Accounting in Chapter 1. We also include marginal references to ***Related Concepts*** throughout the book. The GASB's conceptual framework is discussed in Chapters 17 and 18.
5. Questions or problems related to ***Business Ethics*** are included in the end-of chapter materials for every chapter.
6. We include real-company annual reports or excerpts from reports with related questions ***(Analyzing Financial Statements)*** in the end-of-chapter materials and/or online for most chapters excluding Chapters 15 and 16.
7. In Chapter 9 of the 6th edition, the homework material includes the effective interest, in addition to the straightline method for amortization of bond premiums and discounts. The 6th edition also includes online appendices on deferred taxes which are related to the topics in Chapter 6 and 7. (Go to www.wiley.com/go/jeter/AdvancedAccounting7e.)
8. The ***in-the-news*** boxes that appear throughout the book reflect recent business and economic events relevant to the subject matter.
9. We have integrated ***goodwill impairment*** into some illustrations in the body of Chapter 5, as well as in several homework problems. We illustrate the newly modified goodwill impairment test. The simplification of the goodwill impairment tests for smaller companies is also discussed, along with the role of qualitative factors for determining which steps are necessary. There are exercises on this topic in Chapters 2 and 5.
10. At the beginning of Chapter 4, we discuss three methods of accounting for investments, depending on the level of ownership and the presumption of influence or control. We emphasize the importance of the complete equity method for certain investments that are not consolidated, or in the parent-only statements. In addition, online materials include an expanded discussion of the ***accounting for investments***. (See www.wiley.com/go/jeter/AdvancedAccounting7e.)
11. ***Learning objectives*** are included in the margins of the chapters, and relevant learning objective numbers are provided with end-of-chapter materials.
12. We continue the use of ***graphical illustrations***, which was introduced in prior editions.
13. A few short-answer questions (and solutions) are periodically provided throughout each chapter to enable students to test their knowledge of the content before moving on.
14. The organization of the worksheets applies a format that separates accounts to the income statement, the statement of retained earnings, and the balance sheet in distinct sections. The worksheets are placed near the relevant text.
15. All illustrations are printed upright on the page and labeled clearly for convenient study and reference.
16. Entries made on consolidated statements workpapers are presented in general journal form. These entries are shaded in blue to distinguish them from book entries, to facilitate exposition and study. To distinguish among parent company entries and workpaper entries in the body of the text, we present parent entries in gray and workpaper entries in blue.
17. We include a feature that requires students to research the FASB Codification in order to locate the current standard that applies to various issues. These exercises appear before the problems at the end of each chapter and often, but not always, relate to topics addressed in that chapter. (Similar questions appear on the CPA exam.)
18. Summaries appear at the end of each chapter, and a glossary of key terms is provided at the end of the book.
19. An appendix to Chapter 1 has been posted online at www.wiley.com/go/jeter/AdvancedAccounting7e. This appendix illustrates a strategy or technique for analyzing a given company, such as a potential acquisition target. This strategy may be applied in some of the end-of-the-chapter Analyzing Financial Statements (AFS) problems.
20. Chapters 17 through 19 reflect the latest GASB and FASB pronouncements related to fund accounting.

Clearly, there are more topics in this text than can be covered adequately in a one semester or one-quarter course. We believe that it is generally better for both students and instructors to cover a selected number of topics in depth rather than to undertake a superficial coverage of a larger number of topics. Modules of material that an instructor may consider for exclusion in any one semester or quarter include the following:

- Chapters 7–9. An expanded analysis of problems in the preparation of consolidated financial statements.
- Chapter 10. Insolvency—liquidation and reorganization.

- Chapters 11–14. International accounting, foreign currency transactions and translation, and segment and interim reporting.
- Chapters 15 and 16. Partnership accounting.
- Chapters 17 through 19. Fund accounting, accounting for governmental units, and accounting for nongovernment–nonbusiness organizations (NNOs).

SUPPLEMENTS

The following supplements are available on the book companion web site: Study Guide, Excel Templates, Power-Point Slides, Instructors' Manual, Solutions Manual, Test Bank, and videos for each chapter. These materials are accessible from www.wiley.com/go/jeter/AdvancedAccounting7e.

WILEYPLUS

WileyPLUS is an online learning and assessment environment, where students test their understanding of concepts, get feedback on their answers, and access learning materials such as the eText and multimedia resources. Instructors can automate assignments, create practice quizzes, assess students' progress, and intervene with those falling behind.

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CONTENTS

1

INTRODUCTION TO BUSINESS COMBINATIONS AND THE CONCEPTUAL FRAMEWORK

CHAPTER CONTENTS

LEARNING OBJECTIVES

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

1.1 GROWTH THROUGH MERGERS

Growth through mergers and acquisitions (M&A) has become a standard in business not only in America but throughout the world. The total volume of 2017 deal-making reached $3.5 trillion, increasing the record streak to four consecutive years in which deals surpassed $3 trillion in volume. In 2017, the United States remained the most active region conducting 12,400 deals, an all-time U.S. record. U.S. deals totaled $1.4 trillion, falling 16% from 2016. Dealmakers expect an M&A surge in 2018 as a result of President Trump's corporate tax reform.

The total volume of Asia Pacific deals reached $912 billion in 2017, up 11% from 2016. Chinese companies committed $140 billion to outbound deals in 2017, down 35% from 2016 but still China's second biggest year on record. A new capital controls regime in China, coupled with increased scrutiny of tech deals from U.S. and European governments, limited outbound deals.[1] In the new millennium, the most recent in a series of booms in merger activity was sparked by cheaper credit and by global competition, in addition to the usual growth-related incentives predominant during the boom of the 1990s.

Merger activity has historically been highly correlated with the movement of the stock market. Increased stock valuation increases a firm's ability to use its shares to acquire other companies and is often more appealing than issuing debt. During the merger cycle of the 1990s, equity values fueled the merger wave. The slowing of merger activity in the early years of the 21st century provided a dramatic contrast to this preceding period. Beginning with the merger of Morgan Stanley and Dean Witter Discover and ending with the biggest acquisition to that date—WorldCom's bid for MCI—the year 1997 marked the third consecutive year of record M&A activity. The pace accelerated still further in 1998 with unprecedented merger activity in the banking industry, the auto industry, financial services, and telecommunications, among others. This activity left experts wondering why and whether bigger was truly better. It also left consumers asking what the impact would be on service. A wave of stock swaps was undoubtedly sparked by record highs in the stock market, and stockholders reaped benefits from the mergers in many cases, at least in the short run. Regulators voiced concern about the dampening of competition, and consumers were quick to wonder where the real benefits lay. Following the accounting scandals of 2001 (WorldCom, Enron, Tyco, etc.), merger activity lulled for a few years.

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

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

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

However, by the end of 2008, a decline in overall merger activity was apparent as the U.S. economy slid into a recession, and some forecasters were predicting the

[1] http://www.ft.com/content/9f0270aa-eabf-11e7-bd17-521324c81e23.

next chapter in M&A to center around bankruptcy-related activity. Data from Thomson Reuters revealed that in 2008, bankruptcy-related merger activity increased for the first time in the last six years. For example, the number of Chapter 11 M&A purchases rose from 136 for the entire year of 2007 to 167 for the first 10 months of 2008, with more to come. Overall mergers, on the other hand, decreased from $87 billion in the United States ($277 billion globally) during October 2007 to $78 billion in the United States ($259 billion globally) during October 2008, based on the Reuters data.

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

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

IN THE NEWS

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

IFRS

IN THE NEWS

In 2017, 86% of private equity investors anticipate an uptick in M&A activity. Divestitures may be a major focus in 2017.

Planning M&A in a Changing Environment and Under Changing Accounting Requirements

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

Growth is a major objective of many business organizations. Top management often lists growth or expansion as one of its primary goals. A company may grow slowly, gradually expanding its product lines, facilities, or services, or it may skyrocket almost overnight. Some managers consider growth so important that they say their companies must "grow or die." In the past hundred years, many U.S. businesses have achieved their goal of expansion through business combinations. A **business combination** occurs when *the operations of two or more companies are brought under common control*.

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

[3] BDO Seidman, LLP, "Client Advisory," No. 2008-1, 1/31/08.

1.2 NATURE OF THE COMBINATION

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

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

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

IN THE NEWS

Men's Wearhouse acquired all the outstanding shares of Jos. A Bank with a per share offer that represented a 56% premium over Jos. A. Bank's closing share price. During a six-month period, Jos. A. Bank made several offers to acquire Men's Wearhouse. At the end of this six-month period, Men's Wearhouse, using a Pac Man strategy, made an offer to acquire Jos. A Bank. No rebranding of the companies is expected and Men's Wearhouse shareholders hope to benefit from $100 to $150 million in synergies.[4]

Defense Tactics

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

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

LO 4 Defensive tactics are used.

1. *Poison pill:* Issuing stock rights to existing shareholders enabling them to purchase additional shares at a price below market value, but exercisable only in the event of a potential takeover. This tactic has been effective in some instances, but bidders may take managers to court and eliminate the defense. In other instances, the original shareholders benefit from the tactic. Chrysler Corp. announced that it was extending a poison pill plan until February 23, 2008, under which the rights become exercisable if anyone announces a tender offer for 15% or more, or acquires 15%, of Chrysler's outstanding common shares. Poison pills are rarely triggered, but their existence serves as a preventative measure.
2. *Greenmail:* The purchase of any shares held by the would-be acquiring company at a price substantially in excess of their fair value. The purchased shares are then held as treasury stock or retired. This tactic is largely ineffective because it may result in an expensive excise tax; further, from an accounting perspective, the excess of the price paid over the market price is expensed.

[4] "Men's Wearhouse Reaches $1.8 Billion Deal to Acquire Jos. A. Bank," by Maggie McGrath, Forbes.com, 3/11/14.

3. *White knight or white squire:* Encouraging a third firm more acceptable to the target company management to acquire or merge with the target company.
4. *Pac-man defense:* Attempting an unfriendly takeover of the would-be acquiring company.
5. *Selling the crown jewels:* The sale of valuable assets to others to make the firm less attractive to the would-be acquirer. The negative aspect is that the firm, if it survives, is left without some important assets.
6. *Leveraged buyouts:* The purchase of a controlling interest in the target firm by its managers and third-party investors, who usually incur substantial debt in the process and subsequently take the firm private. The bonds issued often take the form of high-interest, high-risk "junk" bonds. Leveraged buyouts will be discussed in more detail in Chapter 2.

1.3 BUSINESS COMBINATIONS: WHY? WHY NOT?

LO 2 Reasons firms combine.

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

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

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

IN THE NEWS

Views on whether synergies are real or simply a plug figure to justify a merger that shouldn't happen are diverse. Time Warner, for example, has fluctuated back and forth on this issue in recent years. President Jeffrey Bewkes recently was quoted as saying, "No division should subsidize another." When queried about the message his predecessors sent to shareholders, he said, "It's bull—"[5]

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

   Management of the acquiring company can draw upon the operating history and the related historical database of the acquired company for planning purposes. A history of profitable operations by the acquired company may, of course, greatly reduce the risk involved in the new undertaking. A careful examination of

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

GAINS FROM BULKING UP[6]

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

the acquired company's expenses may reveal both expected and unexpected costs that can be eliminated. On the more negative (or cautious) side, be aware that the term "synergies" is sometimes used loosely. If there are truly expenses that can be eliminated, services that can be combined, and excess capacity that can be reduced, the merger is more likely to prove successful than if it is based on growth and "so-called synergies," suggests Michael Jensen, a professor of finance at the Harvard Business School.

2. Combination may enable a company to compete more effectively in the **international marketplace**. For example, an acquiring firm may diversify its operations rather rapidly by entering new markets; alternatively, it may need to ensure its sources of supply or market outlets. Entry into new markets may also be undertaken to obtain cost savings realized by smoothing cyclical operations. Diminishing savings from cost-cutting *within* individual companies makes combination more appealing. The financial crisis in Asia accelerated the pace for a time as American and European multinationals competed for a shrinking Asian market. However, a combination of growing competition, globalization, deregulation, and financial engineering has led to increasingly complex companies and elusive profits.
3. Business combinations are sometimes entered into to take advantage of **income tax** laws. The opportunity to file a consolidated tax return may allow profitable corporations' tax liabilities to be reduced by the losses of unprofitable affiliates. When an acquisition is financed using debt, the interest payments are tax deductible, creating a **financial synergy** or "tax gain." Many combinations in the past were planned to obtain the advantage of significant operating loss carryforwards that could be utilized by the acquiring company. However, the Tax Reform Act of 1986 limited the use of operating loss carryforwards in merged companies. Because tax laws vary from year to year and from country to country, it is difficult to do justice to the importance of tax effects within the scope of this chapter. Nonetheless, it is important to note that tax implications are often a driving force in merger decisions.
4. **Diversification** resulting from a merger offers a number of advantages, including increased flexibility, an internal capital market, an increase in the firm's debt capacity, more protection from competitors over proprietary information, and, sometimes, a more effective utilization of the organization's resources. In debating

IN THE NEWS

Having incurred heavy losses over the last several decades, the U.S. airline industry is often considered a laggard by investors. Consequently, a number of airlines were pushed into bankruptcy post the slowdown, resulting in a number of M&A over the last decade. These mergers resulted in the consolidation of capacity with the top four U.S. airlines in the industry, namely American, United, Delta, and Southwest Airlines. At present, these airlines hold almost 85% of the market share, as opposed to only 65% share (on average) held by the top four U.S. airlines in the past.[7]

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

[7] *Forbes*, "How M&A Has Driven the Consolidation of the US Airline Industry over the Last Decade? 5/4/16.

the tradeoffs between diversification and focusing on one (or a few) specialties, there are no obvious answers.

5. **Divestitures** accounted for 40% of global merger activity in 2014, which has increased from 30% in the period from 2001 to 2010. Shedding divisions that are not part of a company's core business became common during this period. In some cases, the divestitures may be viewed as "undoing" or "redoing" past acquisitions. A popular alternative to selling off a division is to "spin off" a unit. Examples include AT&T's spin-off of its equipment business to form ***Lucent Technologies Inc.,*** Sears Roebuck's spin-off of ***Allstate Corp.*** and ***Dean Witter Discover & Co.,*** and Cincinnati Bell's proposed spin-off of its billing and customer-management businesses to form ***Convergys Corp.***

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

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

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

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

1.4 BUSINESS COMBINATIONS: HISTORICAL PERSPECTIVE

LO 1 Historical trends in types of M&A.

In the United States there have been three fairly distinct periods characterized by many business mergers, consolidations, and other forms of combinations: 1880–1904, 1905–1930, and 1945–present. During the first period, huge holding companies, or trusts, were created by investment bankers seeking to establish monopoly control over certain

industries. This type of combination is generally called **horizontal integration** because it involves the combination of companies within the same industry. Examples of the trusts formed during this period are J. P. Morgan's U.S. Steel Corporation and other giant firms such as Standard Oil, the American Sugar Refining Company, and the American Tobacco Company. By 1904, more than 300 such trusts had been formed, and they controlled more than 40% of the nation's industrial capital.

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

The third period started after World War II and has exhibited rapid growth in merger activity since the mid-1960s, and even more rapid growth since the 1980s. The total dollar value of M&A grew from under $20 billion in 1967 to over $300 billion by 1995 and over $1 trillion in 1998, and $3.5 trillion by 2006. Even allowing for changes in the value of the dollar over time, the acceleration is obvious. By 1996, the number of yearly mergers completed was nearly 7,000. Some observers have called this activity **merger mania**, and most agreed that the mania had ended by mid-2002. However, by 2006, merger activity was soaring once more. Illustration 1-1 presents two rough graphs of the level of merger activity for acquisitions over $10 million from 1985 to 2017 in number of deals, and from 1985 to 2017 in dollar volume. Illustration 1-2 presents summary statistics on the level of activity for the years 2000 through 2018 by industry sector for acquisitions with purchase prices valued in excess of $10 million.

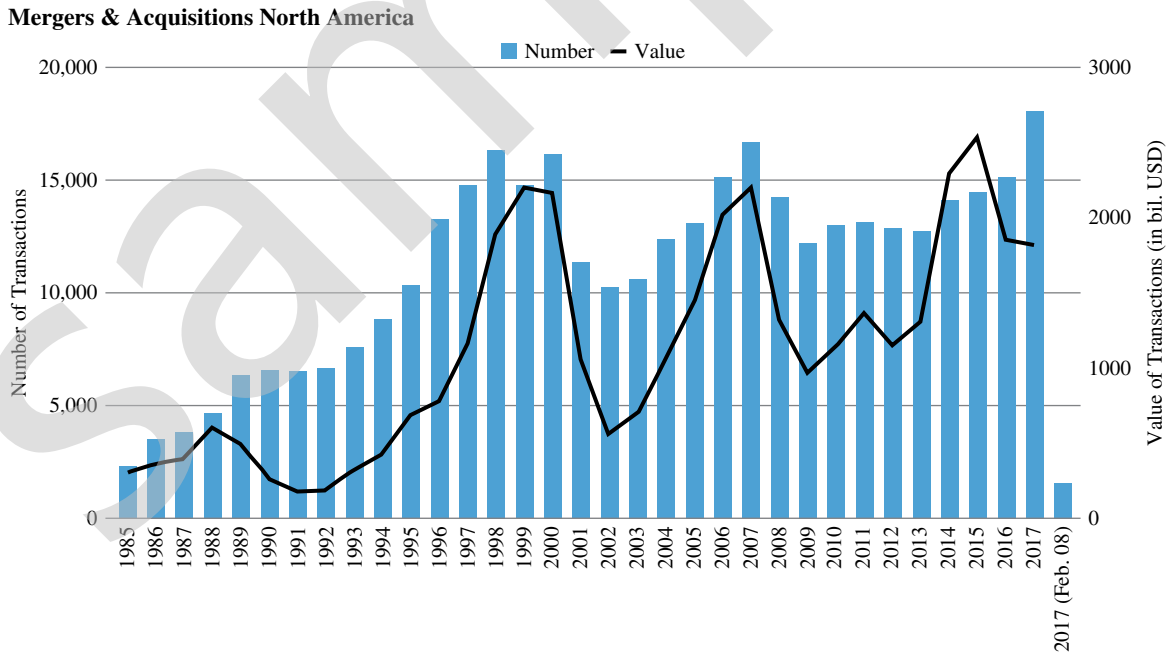
This most recent period can be further subdivided to focus on trends of particular decades or subperiods. For example, many of the mergers that occurred in the United States from the 1950s through the 1970s were **conglomerate** mergers. Here the primary motivation for combination was often to diversify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

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

1960s and 1970s proved unsuccessful; in fact, some of the takeovers of the 1980s were of a disciplinary nature, intended to break up conglomerates.

Deregulation undoubtedly played a role in the popularity of combinations in the 1990s. In industries that were once fragmented because concentration was forbidden, the pace of mergers picked up significantly in the presence of deregulation. These industries include banking, telecommunications, and broadcasting. Although recent

ILLUSTRATION 1-1 Number and Value of M&A North America 1985 to 2017



https://imaa-institute.org/mergers-and-acquisitions-statistics/

ILLUSTRATION 1-2

Ten Most Active Industries (Domestic Deals) by Number and Value of Transactions from 2000 to 2018

	Number of Deals			*Value of Deals*		
Industry	*Rank*	*Number of Deals*	*% of all M&A Deals*	*Rank*	*Value ($ billions)*	*% of Total M&A Value*
High Technology	1	38,350	19.91%	3	2,807	12.10%
Financials	2	22,049	11.45%	4	2,779	11.98%
Consumer Products	3	21,816	11.32%	11	875	3.77%
Industrials	4	20,863	10.83%	6	1,745	7.52%
Healthcare	5	16,592	8.61%	1	3,292	14.19%
Media and Entertainment	6	15,203	7.89%	5	2,362	10.18%
Energy and Power	7	13,978	7.26%	2	3,078	13.27%
Materials	8	13,843	7.19%	8	1,494	6.44%
Real Estate	9	9,010	4.68%	7	1,521	6.56%
Retail	10	7,909	4.11%	12	647	2.79%
Consumer Staples	11	7,649	3.97%	10	1,269	5.47%
Telecommunications	12	5,387	2.80%	9	1,333	5.75%
		192,649	100.00%		23,202	100.00%

Source: Institute of Mergers, Acquisitions and Alliances (IMAA), retrieved from https://imaa-institute.org/mergers-and-acquisitions-statistics

years have witnessed few deals blocked due to antitrust enforcement, an example of a major transaction dropped in 1996 because of a planned FTC (Federal Trade Commission) challenge was in the drugstore industry. The FTC challenged the impact of a proposed merger between ***Rite Aid Corp.*** and ***Revco D.S. Inc.*** on market power in several sectors of the East and Midwest. Nonetheless, subsequent deals in the industry saw both companies involved: Rite Aid acquired ***Thrifty PayLess Holdings Inc.,*** and ***CVS Inc.*** purchased Revco in February 1997.

Later, the Justice Department sued to block Primestar's acquisition of a satellite slot owned by ***MCI*** and ***News Corp.*** Other deals were dropped in the face of possible intervention, including a planned merger between CPA firms KPMG Peat Marwick and Ernst & Young in 1998. Nonetheless, over time the group of large CPA firms once referred to as the Big 8 has blended into the Big 4, raising concerns about a possible lack of competition in the audit market for large companies. The Justice Department reached a settlement in 2013 with American Airlines and US Airways requiring them to sell facilities at seven airports before being allowed to consummate the planned merger.[8]

In Broadcom's bid for Qualcomm, the chipmaker agreed to pay an $8 billion breakup fee should the deal ultimately be blocked by regulators, representing the second largest breakup fee ever recorded. Of the ten deals with the largest breakup fees, three were ultimately terminated resulting in a $3–$3.5 billion loss for the acquirer (T-Mobile and AT&T in 2011, Baker Hughes and Halliburton in 2016, and Pfizer and Allergan in 2016).[9]

IN THE NEWS

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

1.5 TERMINOLOGY AND TYPES OF COMBINATIONS

LO 5 Stock versus asset acquisitions.

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

Note that the distinction between an asset acquisition and a stock acquisition does not imply anything about the medium of exchange or consideration used to consummate the acquisition. Thus a firm may gain control of another firm in a stock acquisition using cash, debt, stock, or some combination of the three as consideration. Alternatively, a firm may acquire the total assets of another firm using cash, debt,

[8] CNN Money, "US Air and American Airlines Reach Deal with Justice to Allow Merger," by C. Isadore and E. ¸Perez, 11/12/2013.

[9] http://www.bloomberg.com/gadfly/articles/2018-02-14/broadcom-s-8-billion-breakup-pledge-to-qualcomm-shows-chutzpah

stock, or some combination of the three. There are two independent issues related to the consummation of a combination: what is acquired (assets or stock) and what is given up (the consideration for the combination). These are shown in Illustration 1-3.

In an analysis of mergers involving a public acquirer from 2001 to 2017, the authors found that approximately 30% of deals used cash only as the consideration until around 2014, when the percentage of deals consummated using only cash began a sharp decline. By 2017, the percentage of cash-only deals was cut in half, to a new average of 15%. The percentage of deals consummated using stock only was around 25% in 2001 but declined shortly thereafter to approximately 10% and remained at this level until 2014. It too began a decline, though less dramatic and appears to have stabilized at about 7 to 8%. The change in recent years has likely been driven by low interest rates and inexpensive debt financing.

In an asset acquisition, a firm must acquire 100% of the assets of the other firm. In a stock acquisition, a firm may obtain control by purchasing 50% or more of the voting common stock (or possibly even less). This introduces one of the most obvious advantages of the stock acquisition over the asset acquisition: a lower total cost in many cases. Also, in a stock acquisition, direct formal negotiations with the acquired firm's management may be avoided. Further, there may be advantages to maintaining the acquired firm as a separate legal entity. The possible advantages include liability limited to the assets of the individual corporation and greater flexibility in filing individual or consolidated tax returns. Finally, regulations pertaining to one of the firms do not automatically extend to the entire merged entity in a stock acquisition. A stock acquisition has its own complications, however, and the economics and specifics of a given situation will dictate the type of acquisition preferred.

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

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

Statutory Merger

A Company + B Company = A Company

ILLUSTRATION 1-3

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

IN THE NEWS

Synergistic deals may be viable even in the current environment, given adequate flexibility and preparation. Although the successful financing of large deals depends largely on capital markets, local middle market deals—say, less than $20 million—more often rely on a combination of commercial loans, seller financing, and equity from private sources or a private equity group.[10]

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

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

Statutory Consolidation

A Company	+	B Company	=	C Company

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

A **stock acquisition** occurs when *one corporation pays cash or issues stock or debt for all or part of the voting stock of another company, and the acquired company remains intact as a separate legal entity*. When the acquiring company acquires a controlling interest in the voting stock of the acquired company (for example, if A Company acquires 50% of the voting stock of B Company), a parent–subsidiary

TEST YOUR KNOWLEDGE 1.1

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

Short Answer

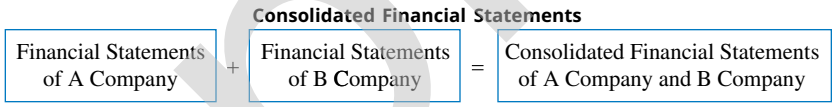
1. Name the following takeover defense tactics:
   a. Issuing stock rights to existing shareholders, enabling them to purchase additional shares at a price below market value, but exercisable only in the event of a potential takeover. _____
   b. The purchase of a controlling interest in the target firm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

Multiple Choice

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

[10] "The Credit Puzzle," by Lou Banach and Jim Gettel, Mergers & Acquisitions, December 2008.

relationship results. Consolidated financial statements (explained in later chapters) are prepared and the business combination is often expressed as



1.6 TAKEOVER PREMIUMS

IN THE NEWS

CVS Health Corp.'s outstanding bonds fell Tuesday, as the company completed an offering of $40 billion in new debt to be used to finance the company's proposed $69 billion acquisition of Aetna Corp. "The combination of CVS and Aetna will create a one-of-a-kind vertically integrated health-care company with huge scale and mark an industry shift toward a more seamless approach to managing health-care costs as it brings together the overall management of a patient's medical bills and prescription drugs under one umbrella," Moody's Vice President Mickey Chadha said in a note. "However, the transaction will result in significant weakening of CVS's credit metrics as it will be financed with a large amount of debt and will come with high execution and integration risks."[11]

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

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

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

One research study presented evidence that higher premiums were offered for firms with high cash flows, relatively low growth opportunities, and high tax liabilities relative to their equity values.[12] Another study suggested that the bigger the ego of the acquiring firm's CEO, the higher the takeover premium, while still another suggested that any premium over 25% is extremely risky.[13] Some compensation analysts argue that the massive options payouts to executives combined with golden parachutes provide an unhealthy incentive for executives to negotiate mergers, citing Chrysler's merger with Daimler-Benz as an example.[14]

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

[11] www.marketwatch.com, by Ciara Linnane, 3/7/18.

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

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

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

IN THE NEWS

Some statistics suggest that of "6000 acquisitions, only 900 return the cost of capital. It is easy to do deals. It is very difficult to make them succeed."[16]

stock prices are a double-edged sword for financial buyers because they mean high prices for both companies' stocks and costlier acquisitions. Also, when stock prices fluctuate, the agreed-upon purchase price may suddenly appear more or less attractive than it did at the time of agreement. For example, a proposed acquisition of ***Comsat Corp.*** by Lockheed Martin Corp. was announced in September 1998, with the acquisition valued at $2.6 billion, of which 49% was to be paid in cash and the rest in Lockheed stock. When Lockheed Martin's stock price subsequently faltered enough to suggest a 16% drop in the total value of the transaction, Comsat shareholders questioned whether the consideration for the transaction was fairly priced.[15]

1.7 AVOIDING THE PITFALLS BEFORE THE DEAL

IN THE NEWS

In a survey of 101 corporations that completed a merger or acquisition transaction of at least $100 million, KPMG found that 93% of companies queried believed that their deal enhanced shareholder value and over a third said they would not do anything different in subsequent deals. However, KPMG's objective examination of the deals showed that only 31% of these deals improved value. KPMG concluded that many companies may not be prepared to make an honest assessment of the success of their deals in order to avoid making mistakes in future deals.[17]

LO 3 Factors to be considered in due diligence.

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

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

IN THE NEWS

An important part of a buyer's preparation involves the development of a due diligence report (sometimes by a public accounting firm) for the purpose of uncovering "skeletons in the closet" (like vendor reliance or customer concentrations). These reports offer a fairly objective perspective of the business, so sharing them with potential lenders is one way of building trust and confidence in the collateral and cash flow. Most lenders prefer a 1-to-1 loan-to-collateral ratio in any deal and regular monitoring through a monthly borrowing base. A lot of the scrutiny by senior lenders gets directed to the buyer's credentials and familiarity with the industry.[18]

[15] *WSJ*, "Lockheed Bid for Comsat Hits Obstacles," by Anne Marie Squeo, 6/11/99, p. A3.

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

[17] *KPMG Transaction Services*, "The Morning After—Driving for Post Deal Success," 1/31/06.

[18] "The Credit Puzzle," by Lou Banach and Jim Gettel, Mergers & Acquisitions, December 2008.

In addition to liabilities that are on the books of the acquired firm, be aware of the possibility of less obvious liabilities. FASB ASC Section 805–20–25 [Recognition] requires an acquiring firm to recognize at fair value all assets acquired and liabilities assumed, whether or not shown in the financial statements of the acquired company.[19]

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

FASB ASC topic 805 [Business Combinations] also states that any costs associated with restructuring or exit activities should not be treated as liabilities at the acquisition date unless they meet the criteria for recognition laid out in FASB ASC paragraph 420-10-15-2.[21] Instead, costs not meeting these criteria should be expensed in the period in which they are incurred. For example, future costs expected with regard to exiting an activity of the target, terminating the employment of the acquiree's employees, or relocating those employees are not accounted for as part of the business combination.[22]

IN THE NEWS

"While everything in the offering memorandum may very well be true, although not necessarily, the facts are designed to make the company look better than it would if an analyst were to dig into those facts."[23]

3. Watch out for the impact on earnings of the **allocation of expenses** and the effects of production increases, standard cost variances, LIFO liquidations, and by-product sales. For example, a firm that is planning to be acquired may grow inventory levels in order to allocate its fixed costs over more units, thus decreasing the cost of goods sold and increasing the bottom line. However, the inventory level that is acquired may be excessive and ultimately costly.
4. Note any **nonrecurring items** that may have artificially or temporarily boosted earnings. In addition to nonrecurring gains or revenues, look for recent **changes in estimates**, **accrual levels**, ***and* methods**. While material changes in method are a required disclosure under GAAP, the rules on materiality are fuzzy, and changes in estimates and accruals are frequently not disclosed (see Illustration 1-4).
5. Be careful of **CEO egos**. Striving to be number one may make business sense, but not everyone can hold that spot. One CEO drew both praise and criticism with his deal-of-the-month style. He stated, "There are the big dogs, there are the ankle-biters, and then there are those caught in the middle." The midsize firms have to combine, he claimed.[24]

[19] See the section later in the chapter on the FASB Codification.

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

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

[22] FASB's new Codification system, referenced here, is discussed near the end of Chapter 1.

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

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

ILLUSTRATION 1-4

Mode of Payment in M&A Deals

	% of All Deals					
	Cash Only		*Stock Only*		*Earnouts*	
Year	*#*	*%*	*#*	*%*	*#*	*%*
2010	416	35.6%	136	11.6%	97	8.3%
2011	386	32.6%	114	9.6%	113	9.5%
2012	460	36.6%	98	7.8%	101	8.0%
2013	445	37.5%	113	9.5%	92	7.7%
2014	498	35.1%	137	9.7%	111	7.8%
2015	283	22.9%	83	6.7%	96	7.7%
2016	172	17.8%	59	6.1%	70	7.2%
2017	117	13.6%	52	6.1%	61	7.1%

Source: Thomson SDC Platinum

1.8 DETERMINING PRICE AND METHOD OF PAYMENT IN BUSINESS COMBINATIONS

LO 6 Factors affecting price and method of payment.

Whether an acquisition is structured as an asset acquisition or a stock acquisition, the acquiring firm must choose to finance the combination with cash, stock, or debt (or some combination). The cash-only financed portion of acquisition prices dropped approximately 10% from the early 2000s to an average of 63% between 2010 and 2014 and has continued to drop to less than 30%. The number of deals financed with stock-only increased by 6% to an average of 20% between 2010 and 2014, but has since dropped to less than 10%. Earnouts were used in approximately 7% to 9% of acquisitions.

The mode of payment also affects the number of days it takes to complete the merger (from the announcement date to the effective date). The following schedule provides the average days to complete a merger for various modes of payment in an acquisition.

Mode of Payment*	**Days to Complete Acquisition**	
	Public Targets	*Private Targets*
Common stock	158 days	90 days
Cash only	84 days	67 days
Earnout	75 days	48 days

* SDC Platinum (2010 to 2013).

As can be seen, if earnouts are used as part of the consideration, the time to complete the merger is significantly shorter (especially for private acquisitions, with an average of 48 days). Acquisitions using stock generally take much longer to complete. Information on the mode of payment in M&A is provided in Illustration 1-4.

The trends are often explained by fluctuating stock valuations. The higher the acquiring firm's stock valuation, the fewer shares are needed to pay for the acquisition. This means less dilution to existing shareholders, a frequent concern in the planning stages of a proposed acquisition. When stock prices slumped in the middle of 2001, merger activity slowed as well. But by the middle of the decade, both were booming once more. Then, merger activity rose steadily from 2002 to 2006, remained

approximately the same in 2007 as in 2006, and then fell off by the end of 2008 as stock prices plunged and the economy slid into a recession. By 2010, many of the mega-mergers in the making were once again looking to use all (or mostly) stock, as the market moved up.

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

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

In addition, it is not unusual, in an acquisition, for the acquiree to retain all cash as well as the responsibility for paying any interest bearing debt. A potential issue that can arise prior to the transaction close is that the acquiree has incentives to delay payments and collect large receivable balances. Thus acquisitions often include net working capital adjustments (true-up). The acquirer will receive additional consideration if net working capital is below agreed-upon target levels, while the acquiree will receive additional consideration if the target amounts exceed the agreed-upon target amounts.

Net Asset and Future Earnings Contributions

Determination of an equitable price for each constituent company, and of the resulting exchange ratio, requires the valuation of each company's net assets as well as their expected contribution to the future earnings of the new entity. The accountant is often called upon to aid in determining net asset value by assessing, for example, the expected collectibility of accounts receivable, current replacement costs for inventories and some fixed assets, and the current value of long-term liabilities based on current interest rates. To estimate current replacement costs of real estate and other items of plant and equipment, the services of appraisal firms may be needed.

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

EXCESS EARNINGS APPROACH TO ESTIMATING GOODWILL

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

LO 7 Estimating goodwill.

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

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

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

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

c. The normal rate of return on net assets for the industry is 14%.

d. Wanna Buy believes that any excess earnings will continue for seven years and that a rate of return of 15% is required on the investment.

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

Normal earnings for similar firms: ($7,000,000 – $3,200,000) × 14% = $532,000

Expected earnings of target:		
Pretax income of Hot Stuff		$1,059,000
Add: Losses on discontinued operations	175,000	
Reduced depreciation on equipment	20,000	195,000
Subtotal		1,254,000
Subtract: Additional depreciation on building	180,000	
Extraordinary gain	250,000	430,000
Target's expected future earnings		824,000

Excess earnings of target: $824,000 – $532,000 = $292,000 per year

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

Estimated goodwill: $292,000 × 4.16042 = $1,214,843

Implied offering price = Fair value of assets – Fair value of liabilities + Estimated goodwill
= $7,000,000 – $3,200,000 + $1,214,843 = $5,014,843.

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

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

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

IN THE NEWS

Upon the agreement to purchase Creo Inc. for $900 million in cash, Eastman Kodak Company's CEO Daniel Carp stated that the "acquisition will result in some modest earnings dilution for the remainder of 2005." However, Carp expects that the Creo transaction will be accretive in 2006, adding "at least 5 cents to per-share operational earnings, driven by cost savings and revenue growth available to the combined entity."[25]

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

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

Many deals lower earnings per share initially but add significantly to value in later years. While initial dilution may not be a deal killer, however, many managers feel that they cannot afford to wait too long for a deal to begin to show a positive return. Opinions are divided, however, on what drives the market in relation to M&A, nor do research studies offer conclusive evidence on the subject. Bart Madden, a partner in a valuation advisory firm in Chicago, remarked, "I totally disagree that the market is EPS driven. From the perspective of the owner or manager of capital, what matters is cash in, cash out, not reported earnings."[26] He acknowledges, however, that CFOs, who "live in a world of accounting rules," are concerned about reported earnings.

IN THE NEWS

KPMG conducts research into mergers approximately every two years. The results show that what was true in past years remains accurate today. That is, only about one-third of mergers, acquisitions, and takeovers add value in North America while almost 70% actually reduce shareholder worth or, at best, are neutral.[27]

Evaluating Firm Performance Supplemental Appendix 1A is available from your instructor, provides a structured approach using ratios to evaluate the performance of a firm. This approach could be used to evaluate the financial performance of a potential target or in evaluating the strength of an acquirer. The ratio approach begins by analyzing the change in return on equity (ROE). This ratio is then decomposed into a return on asset (ROA) and a leverage ratio (total assets divided by equity). These ratios are further decomposed into other relevant combinations of variables. This structured approach allows the user to zero in on areas that have changed or that need to be examined in more detail.

1.9 ALTERNATIVE CONCEPTS OF CONSOLIDATED FINANCIAL STATEMENTS

LO 8 Economic entity and parent company concepts.

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

Historically, practice in the United States has reflected a compromise between two general concepts of consolidation given various designations in the accounting

[26] *CFO*, "Say Goodbye to Pooling," by Ian Springsteel, February 1997, p. 79.

[27] "Why Most Acquisitions Fail," KPMG webcast, 1/31/17.

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

Although only one of these—the economic entity concept—is embraced by current GAAP and thus integrated throughout this text, the two more popular concepts are described below (as defined by the Financial Accounting Standards Board).[28]

Parent Company Concept

> The parent company concept emphasizes the interests of the parent's shareholders. As a result, the consolidated financial statements reflect those stockholder interests in the parent itself, plus their undivided interests in the net assets of the parent's subsidiaries. The consolidated balance sheet is essentially a modification of the parent's balance sheet with the assets and liabilities of all subsidiaries substituted for the parent's investment in subsidiaries. Similarly, the consolidated income statement is essentially a modification of the parent's income statement with the revenues, expenses, gains, and losses of subsidiaries substituted for the parent's income from investment in subsidiaries. These multiline substitutions for single lines in the parent's balance sheet and income statement are intended to make the parent's financial statements more informative about the parent's total ownership holdings.

Economic Entity Concept

> The economic entity concept emphasizes control of the whole by a single management. As a result, under this concept, consolidated financial statements are intended to provide information about a group of legal entities—a parent company and its subsidiaries—operating as a single unit. The assets, liabilities, revenues, expenses, gains, and losses of the various component entities are the assets, liabilities, revenues, expenses, gains, and losses of the consolidated entity. Unless all subsidiaries are wholly owned, the business enterprise's proprietary interest (assets less liabilities) is divided into the controlling interest (stockholders or other owners of the parent company) and one or more noncontrolling interests in subsidiaries. Both the controlling and the noncontrolling interests are part of the proprietary group of the consolidated entity. Under this concept, the entirety of subsidiaries assets, liabilities, revenues, and expenses are reflected in the consolidated financial statements. Noncontrolling interest in equity and in income serves to capture the portion not controlled by the parent.

The parent company concept represents the view that the primary purpose of consolidated financial statements is to provide information relevant to the controlling stockholders. The parent company effectively controls the assets and operations of the subsidiary. Noncontrolling stockholders do not exercise any ownership control over the subsidiary company or the parent company. Thus, the parent company concept places emphasis on the needs of the controlling stockholders, and the noncontrolling

[28] *FASB Discussion Memorandum*, "Consolidation Policy and Procedures," FASB (Norwalk, CT: September 10, 1991), paras 63 and 64.

interest is essentially relegated to the position of a claim against the consolidated entity. Thus, the noncontrolling, or minority, interest should be presented as a liability in the consolidated statement of financial position under the parent company concept or, as described in the next section, as a separate component before stockholders' equity.

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

The FASB stated that it had considered and rejected the concept of proportionate consolidation for subsidiaries. This concept, although not used in current or past practice, has been advocated by some as an alternative to full consolidation. Under proportionate consolidation, the consolidated statements would include only a portion, based on the parent's ownership interest, of the subsidiary's assets, liabilities, revenues, expenses, gains, and losses. The FASB stated that because the consolidated entity has the power to direct the use of all the assets of a controlled entity, omitting a portion of those assets from the statements would not be representationally faithful. Similarly, omitting part of the revenues and expenses from the consolidated income statement would not be representationally faithful.

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

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

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

Noncontrolling Interest

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

Between 2001 and 2017, approximately 4% of acquisitions resulted in a noncontrolling interest. However, when public firms are acquired, this percentage increases to

6.6%. The percentage of private targets with noncontrolling interests is lower around 3.8%. One interesting fact is that in the two years preceding the issuance of *FASB Statement No. 141R* the number of acquisitions with NCI averaged over 11%.

Consolidated Net Income

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

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

Consolidated Balance Sheet Values

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

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

Application of the ***economic entity concept*** results in a write-up of the net assets of S Company in the consolidated statements workpaper by $600,000 to $1,600,000 on the theory that the consolidated financial statements should reflect 100% of the net asset values of the affiliated companies. On the date of acquisition, the net assets of

the subsidiary are included in the consolidated financial statements at their book value ($1,000,000) plus the **entire difference** between their fair value and their book value ($600,000), or a total of $1,600,000. Noncontrolling interest is reported at its percentage interest in the **fair value** of the net assets of S Company, or $640,000 (.4 × $1,600,000).

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

	Parent Company Concept	*Economic Unit Concept*
Net assets of S Company included in consolidation	$1,360,000	$1,600,000
Less: Noncontrolling interest	400,000	640,000
Controlling interest (cost)	$ 960,000	$ 960,000

While U.S. standards have, in the past, been more consistent with the parent company concept with respect to write-up of net assets, the implementation of *FASB Statements No. 141R* and *160* [FASB ASC topics 805 and 810] results in a shift to the economic entity concept in this regard, among others.

Intercompany Profit

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

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

Past and Future Practice

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

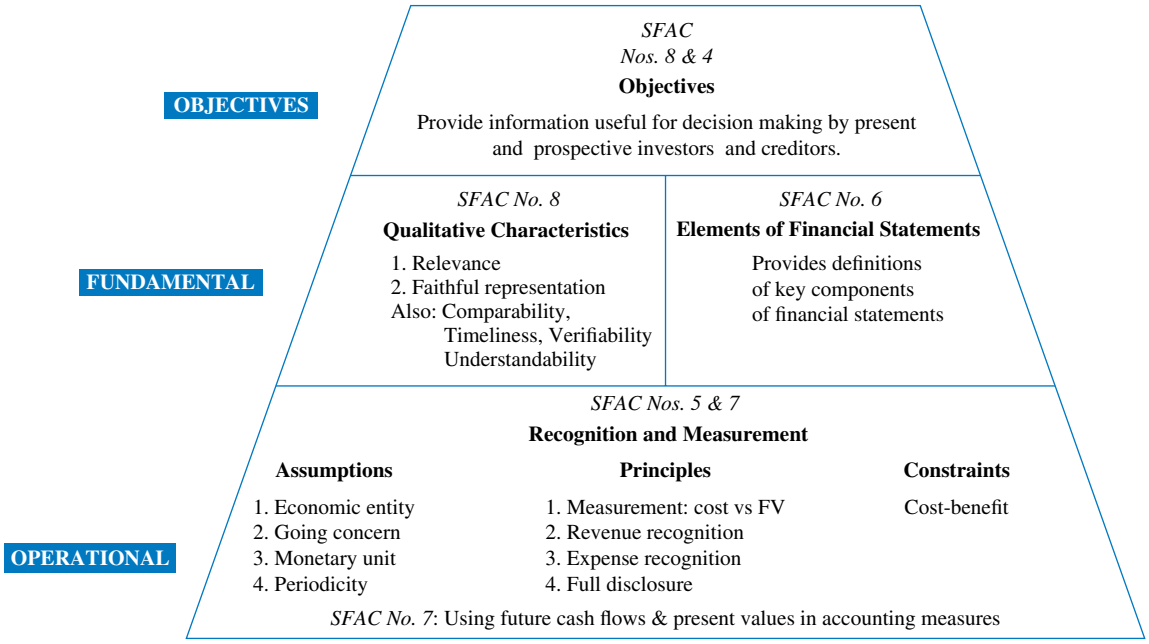
In contrast, under the current standards, the noncontrolling interest in income is viewed as an allocation of consolidated net income on the income statement, and the noncontrolling interest in net assets as a component of equity in the balance sheet.

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

1.10 FASB'S CONCEPTUAL FRAMEWORK

The Financial Accounting Standards Board (FASB) began the process of developing a conceptual framework for financial reporting in 1976, a process that continues to the present. The much-needed objective of providing a basis for standard setting and controversy resolution has, as expected, proved to be challenging. The statements of concepts issued to date are summarized in Illustration 1-5. The reader should be aware that the FASB and the IASB are working on a joint project to converge their conceptual frameworks. The first phase has been completed with the issuance of Statement of Financial Accounting Concepts (SFAC) No. 8: Conceptual Framework for Financial Reporting—Chapter 1, *The Objective of General Purpose Financial Reporting*, and Chapter 3, *Qualitative Characteristics of Useful Financial Information* (a replacement of FASB Concepts Statements Nos. 1 and 2). New chapters and concepts are expected to be added. Concepts Statements are not part of the *FASB Accounting Standards Codification*, which is the source of authoritative GAAP recognized by the FASB to be applied by nongovernmental entities. The Board recognizes that in certain respects current generally accepted accounting principles may be inconsistent with those that may derive from the objectives and fundamental concepts set forth in Concepts Statements. However, a Concepts Statement does not (a) require a change in existing U.S. GAAP; (b) amend, modify, or interpret the Accounting Standards Codification; or (c) justify either changing existing generally accepted accounting and reporting practices or interpreting the Accounting Standards Codification based on personal interpretations of the objectives and concepts in the Concepts Statements.

ILLUSTRATION 1-5 Conceptual Framework for Financial Accounting and Reporting



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

Economic Entity vs. Parent Concept and the Conceptual Framework

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

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

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

IFRS

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

IN THE NEWS

Embedded in many of FASB's recent pronouncements have been a number of indicators of a shift away from historical cost accounting in the direction of fair value accounting. This shift drew a great deal of attention, much of it negative, when the financial crisis of 2008 became apparent. Critics claimed that values were dropping to artificially low values, forcing banks to take large write-downs, launching a desperate cycle from which they might not recover. Dennis Beresford, an accounting professor at the University of Georgia and chairman of the FASB from 1987 to 1997, explained, "It's intended to be more or less for orderly markets. But we don't have orderly markets these days. It's not so much that mark to market has people complaining, but marking to a particular market. Today it's more of fire-sale prices."[29]

[29] "Wall St. Points to Disclosure As Issue," by Carrie Johnson, Washingtonpost.com, 9/23/08.

Overview of FASB's Conceptual Framework

LO 9 Statements of Financial Accounting Concepts.

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

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

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

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

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

SFAC No. 8: (replaces SFAC Nos. 1 and 2): The Objective of General Purpose Financial Reporting and Qualitative Characteristics of Useful Financial Information

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

Linking the Conceptual Framework to Advanced Accounting Issues

We begin with a brief discussion of the two *Statements of Concepts*, which receive the least attention in the following paragraphs (*SFAC No. 4 and SFAC No. 7*). With respect to *SFAC No. 4*, the Board believes that the objectives of reporting for government-sponsored entities should be, in general, similar to those of business enterprises engaged in similar activities. Please see Chapters 17 through 19 for further discussion. Moving to *SFAC No. 7*, the use of present values is clearly relevant in the accounting for business combinations as it impacts the estimated valuation of goodwill (previously illustrated in Chapter 1), as well as other intangible assets acquired in a business combination. Just as clearly, the use of present values is hampered by issues of uncertainty, both about estimated cash flows and about appropriate discount rates. As stated in *SFAC No. 7*, the objective of using present values in an accounting measurement is to capture, to the extent possible, the economic difference between sets of estimated future cash flows. The standard provides some guidance in this regard.

Referring to Illustration 1-5, note that the primary qualities laid out in *SFAC No. 8* are relevance and faithful representation (formerly referred to as reliability). Additional desirable characteristics include comparability, timeliness, and understandability.

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

The issue of comparability plays a role in the more recent shift from the parent concept to the economic entity concept, as the former method valued a portion (the

noncontrolling interest) of a given asset at prior book values and another portion (the controlling interest) of that same asset at exchange-date market value. The result was a piecemeal valuation of assets on the consolidated balance sheet.

Distinguishing between Earnings and Comprehensive Income

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

Turning now to the elements of financial statements, see Illustration 1-6 for a summary of definitions. We might note that earnings is not defined as one of the

ILLUSTRATION 1-6

Definitions of Financial Statement Elements

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

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

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

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

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

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

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

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

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

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

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

elements included in *SFAC No. 6*. In fact, the FASB explicitly stated that it reserved the term earnings for possible use to designate a significant intermediate measure or component of comprehensive income. In *SFAC No. 5*, FASB states that "it is important to avoid focusing attention almost exclusively on the bottom line, earnings per share, or other highly simplified condensations." *SFAC No. 5* goes on to state that "statements of earnings and of comprehensive income together reflect the extent to which, and the ways in which, the equity of an entity increased or decreased from all sources other than transactions with owners during a period." The statement further expresses an expectation that the concept of earnings will evolve or develop over time. *SFAC No. 5* does, however, provide a working definition of earnings as follows:

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

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

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

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

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

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

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

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

IFRS

Asset Impairment and the Conceptual Framework

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

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

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

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

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

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

Supplemental Section 1.11 "FASB Codification (Source of GAAP)," is available from your instructor.

SUMMARY

1. *Describe historical trends in types of business combinations.* Horizontal integration was popular from 1880 to 1904, while vertical integration became more prevalent from 1905 through 1930. The period beginning after World War II was called merger mania. From the 1950s through the 1970s, conglomerate mergers between companies in different industries occurred in the face of antitrust regulation restricting combinations within a particular industry. A relaxation of antitrust regulation in the 1980s and the emergence of high-yield junk bonds led to strategic acquisitions for firms seeking operating synergies. High stock prices in the 1990s created a wealth of mergers with stock as the medium of exchange.
2. *Identify the major reasons firms combine.* Firms combine to achieve growth goals to obtain operating synergies, to compete more effectively in the international marketplace, to take advantage of tax laws in some cases, and to diversify or to eliminate competition.
3. *Identify the factors that managers should consider in exercising due diligence in business combinations.* Be aware of unrecorded liabilities; take care in interpreting percentages quoted by the selling company; examine the impact on earnings from allocated expenses, changes in LIFO reserves and inventory levels, and product sales; note any nonrecurring items, changes in estimates, accruals, or methods; and be careful of CEO egos.
4. *Identify defensive tactics used to attempt to block business combinations.* These tactics include poison pills, greenmail, white knights or white squires, pac-man defense, selling the crown jewels, and leveraged buyouts.
5. *Distinguish between an asset and a stock acquisition.* An asset acquisition involves the purchase of all of the acquired company's net assets, whereas a stock acquisition involves the attainment of control via purchase of a controlling interest in the stock of the acquired company.
6. *Indicate the factors used to determine the price and the method of payment for a business combination.* Factors include the effect of the acquisition on future earnings performance, (dilution or accretion), and the estimated value of the firm's identifiable net assets and implied goodwill. The method of payment is affected by the liquidity position of the purchaser firm, the willingness of the sellers to accept alternative forms of financing, and tax issues.
7. *Calculate an estimate of the value of goodwill to be included in an offering price by discounting expected future excess earnings over some period of years.* Identify a normal rate of return for firms similar to the company being targeted. Apply the rate of return to the level of identifiable assets of the target to approximate what the "normal" firm in this industry might generate. Estimate the expected future earnings of the target, and subtract the "normal" earnings to get "excess earnings." Assume an appropriate time period and a discount rate to calculate the discounted value of the excess earnings.
8. *Describe the two alternative views of consolidated financial statements: the economic entity and the parent company concepts.* Under the parent company concept, the consolidated financial statements reflect the stockholders' interests in the parent, plus their interests in the net assets of the subsidiaries. Thus the focus is on the interests of the parent's shareholders. The economic entity concept emphasizes control of the whole by a single management. As a result, consolidated financial statements provide information about a group of legal entities—a parent company and its subsidiaries—operating as a single unit.
9. *Discuss the Statements of Financial Accounting Concepts (SFAC).* These statements provide a framework for use by FASB in addressing topics that arise and by users in interpreting and implementing FASB standards updates. They address definitions of key terms in financial reporting, its objectives, the role of cash flows and present values, qualitative characteristics of useful information, and underlying principles.

Supplemental Appendix 1A, "Evaluating Firm Performance," is available from your instructor.

TEST YOUR KNOWLEDGE SOLUTIONS

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

QUESTIONS

LO 2 **1.** Distinguish between internal and external expansion of a firm.

LO 2 **2.** List four advantages of a business combination as compared to internal expansion.

LO 1 **3.** What is the primary legal constraint on business combinations? Why does such a constraint exist?

LO 2 **4.** Business combinations may be classified into three types based upon the relationships among the combining entities (e.g., combinations with suppliers, customers, competitors). Identify and define these types.

LO 5 **5.** Distinguish among a statutory merger, a statutory consolidation, and a stock acquisition.

LO 4 **6.** Define a tender offer and describe its use.

LO 6 **7.** When stock is exchanged for stock in a business combination, how is the stock exchange ratio generally expressed?

LO 4 **8.** Define some defensive measures used by target firms to avoid a takeover. Are these measures beneficial for shareholders?

LO 5 **9.** Explain the potential advantages of a stock acquisition over an asset acquisition.

LO 6 **10.** Explain the difference between an accretive and a dilutive acquisition.

LO 8 **11.** Describe the difference between the economic entity concept and the parent company concept approaches to the reporting of subsidiary assets and liabilities in the consolidated financial statements on the date of the acquisition.

LO 8 **12.** Contrast the consolidated effects of the parent company concept and the economic entity concept in terms of:

(a) The treatment of noncontrolling interests.

(b) The elimination of intercompany profits.

(c) The valuation of subsidiary net assets in the consolidated financial statements.

(d) The definition of consolidated net income.

LO 8 **13.** Under the economic entity concept, the net assets of the subsidiary are included in the consolidated financial statements at the total fair value that is implied by the price paid by the parent company for its controlling interest. What practical or conceptual problems do you see in this approach to valuation?

14. Is the economic entity or the parent concept more consistent with the principles addressed in the FASB's conceptual framework? Explain your answer. LO 9

15. How does the FASB's conceptual framework influence the development of new standards? LO 9

16. What is the difference between net income, or earnings, and comprehensive income? LO 9

Business Ethics

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

1. What effect does each of the three items have on the reported net income of the acquired company before the acquisition and on the reported net income of the combined company in the first year of the acquisition and future years?

2. What effect does each of the three items have on the cash from operations of the acquired company before the acquisition and on the cash from operations of the combined company in the first year of the acquisition and future years?

3. If you are the manager of the acquired company, how do you respond to these suggestions?

4. Assume that all three items can be managed within the rules provided by GAAP but would be regarded by many as pushing the limits of GAAP. Is there an ethical issue? Describe your position as: (A) an accountant for the target company and (B) as an accountant for Tyco.

ANALYZING FINANCIAL STATEMENTS

AFS1-1 Tesla announced on August 1, 2016, its intent to buy SolarCity in a deal expected to exceed $2.5 billion dollars. Tesla touted the acquisition because of $150 million in expected cost synergies in the first year. In addition, the new company would be the world's largest vertically integrated energy company (the company would be able to sell electric cars, make and sell energy storage for buildings and the grid, and make and install solar panels). SolarCity's expertise in installing solar panels could bolster installations of Tesla's Powerwalls (Tesla rechargeable Lithium-ion batteries used for domestic consumption). The acquisition is expected to be dilutive to EPS. Further, the combined debt of the two companies would be $6 billion, despite adding $1 billion in revenue to the combined company.

Financial statements for both companies at the end of 2016 are presented below. The acquisition did occur on November 21, 2016. The results for Tesla reported below do include the results of operations for SolarCity from the date of acquisition to the end of the current year (November 21 to December 31, 2016).

	Tesla			*SolarCity*		
For Year Ended December 31: ($ thousands)	***Y 2016***	***Y 2015***	***Y 2014***	***Y 2016***	***Y 2015***	***Y 2014***
Revenues						
Total revenues	$7,000,132	$4,046,025	$3,198,356	$730,342	$399,619	$255,031
Cost of Revenues						
Total cost of revenues	5,400,875	3,122,522	2,316,685	478,922	280,791	176,432
Gross profit	1,599,257	923,503	881,671	251,420	118,828	78,599
Operating Expenses*						
Total operating expenses	2,266,597	1,640,132	1,068,360	901,761	766,618	414,196
Loss from operations	(667,340)	(716,629)	(186,689)	(650,341)	(647,790)	(335,597)
Total Interest and other expenses	(79,008)	(158,995)	(97,947)	170,314	117,706	66,369
Loss before income taxes	(746,348)	(875,624)	(284,636)	(820,655)	(765,496)	(401,966)
Provision for income taxes	26,698	13,039	9,404	308	(3,326)	26,736
Net loss	($773,046)	($888,663)	($294,040)	(820,347)	(768,822)	(375,230)
Other Information						
Research and development expenses*	$834,408	$717,900	$464,700	54,963	64,925	19,162

*included in operating expenses

(1) What does it mean for an acquisition to be dilutive? Why would shareholders vote to approve the acquisition if the acquisition is expected to be dilutive? Why would management prefer the acquisition if it is dilutive?

(2) Provide comments concerning the performance of both companies. Why is it difficult to predict the success of the acquisition?

AFS1-2 **Kraft and Cadbury PLC LO 2 LO 3**

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

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

(1) Discuss some of the factors that should be considered in analyzing the impact of this merger on the income statement for the next few years.

(2) Discuss the pros and cons that Kraft might have weighed in choosing the medium of exchange to consummate the acquisition. Do you think they made the right decision? If possible, use figures to support your answer.

(3) (3)In addition to the factors mentioned above, there are sometimes factors that cannot be quantified that enter into acquisition decisions. What do you suppose these might be in the case of Kraft's merger with Cadbury?

(4) This acquisition is complicated by the lack of consistency between the two companies' methods of accounting and currency. Discuss the impact that these issues are likely to have on the merged company in the years following the acquisition.

AFS1-3

AFS1-2 Kraft Acquires Cadbury PLC LO 3

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

Required:

A. Evaluate the health of the target company and point out any trends that might have been worrisome to Kraft. Also indicate any strengths in the firm's performance. Hint: A supplemental appendix "Evaluating Firm Performance" is available from your instructor and may prove useful in addressing this question.

Kraft Foods ($ millions)	*2007*	*2008*	*2009*
Balance Sheet			
Assets	67,993	63,173	66,714
Total liabilities	40,698	40,817	40,742
Stockholders' equity	27,295	22,356	25,972
Selected Balance Sheet items			
Market value of equity	50,480	48,110	40,111
Current assets	10,737	9,917	12,454
Current liabilities	17,086	11,044	11,491
Accounts receivable	5,197	4,704	5,197
Inventory	4,096	3,881	3,775
Long-term debt	13,624	19,354	18,537
Retained earnings	12,209	13,440	14,636
Income Statement			
Total revenues	37,241	40,492	38,754
Cost of goods sold	24,651	27,164	24,819
Gross margin	12,590	13,328	13,935
Income continuing operations	2,590	1,678	2,810
Net income	2,590	2,884	3,021
Selected Income Statement items			
Interest expense	604	1,240	1,237
Tax expense	1,137	658	1,136
Statement of Cash Flows			
Cash from operations (CFO)	3,571	4,141	5,084
Cash interest paid	628	968	1,308
Cash taxes paid	1,366	964	1,025
Cadbury (£ millions)	***2007***	***2008***	***2009***
Balance Sheet			
Assets	11,338	8,895	8,129
Total liabilities	7,165	5,361	4,607
Stockholders' equity	4,173	3,534	3,522
Selected Balance Sheet items			
Market value of equity	9,581	8,241	12,266
Current assets	2,600	2,635	2,125
Current liabilities	4,614	3,388	2,434
Accounts receivable	1,197	1,067	978
Inventory	821	767	748
Long-term debt	1,120	1,194	1,349
Retained earnings	2,677	2,498	3,502
Income Statement			
Total revenues	4,699	5,384	5,975
Cost of goods sold	5,504	2,870	3,210

Kraft Foods ($ millions)	*2007*	*2008*	*2009*
Gross margin	2,195	2,514	2,765
Income continuing operations	149	370	275
Net income	405	364	509
Selected Income Statement items			
Interest expense	88	50	172
Tax expense	105	30	103
Statement of Cash Flows			
Cash from operations (CFO)	812	469	523
Cash interest paid	193	165	122
Cash taxes paid	235	153	163

B. Evaluate the health of Kraft Foods, and point out any positive or negative trends. Refer to the supplemental appendix "Evaluating Firm Performance."

EXERCISES

EXERCISE 1-1 Estimating Goodwill and Potential Offering Price LO 7

Plantation Homes Company is considering the acquisition of Condominiums, Inc. early in 2020. To assess the amount it might be willing to pay, Plantation Homes makes the following computations and assumptions.

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

B. Condominiums, Inc.'s pretax incomes for the years 2017 through 2019 were $1,200,000, $1,500,000, and $950,000, respectively. Plantation Homes believes that an average of these earnings represents a fair estimate of annual earnings for the indefinite future. However, it may need to consider adjustments to the following items included in pretax earnings:

Depreciation on buildings (each year)	960,000
Depreciation on equipment (each year)	50,000
Extraordinary loss (year 2019)	300,000
Sales commissions (each year)	250,000

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

Required:

A. Assume further that Plantation Homes feels that it must earn a 25% return on its investment and that goodwill is determined by capitalizing excess earnings. Based on these assumptions, calculate a reasonable offering price for Condominiums, Inc. Indicate how much of the price consists of goodwill. Ignore tax effects.

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

EXERCISE 1-2 **Estimating Goodwill and Valuation LO 7**

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

	Beta Company Book Values	*Estimated Market Values*
Total identifiable assets	$585,000	$750,000
Total liabilities	320,000	320,000
Owners' equity	$265,000	

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

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

Required:

A. Compute (a) an offering price based on the information above that Alpha might be willing to pay and (b) the amount of goodwill included in that price.

B. Compute the amount of goodwill actually recorded, assuming the negotiations result in a final purchase price of $625,000 cash.

EXERCISE 1-3 **Estimated and Actual Goodwill LO 7**

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

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

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

Required:

A. Compute an estimation of goodwill based on the information above that Passion might be willing to pay (include in its purchase price), under each of the following additional assumptions:

(1) Passion is willing to pay for *excess* earnings for an expected life of five years (undiscounted).

(2) Passion is willing to pay for *excess* earnings for an expected life of five years, which should be capitalized at the industry normal rate of return.

(3) Excess earnings are expected to last indefinitely, but Passion demands a higher rate of return of 20% because of the risk involved.

B. Comment on the relative merits of the three alternatives in part (A) above.

C. Determine the amount of goodwill to be recorded on the books if Passion pays $800,000 cash and assumes Desiree's liabilities.

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

ASC1-1 **Cross-Reference** The conditions determining what determines the acquisition date was prescribed in *SFAS No. 141R*, paragraph 10. Where is this located in this Codification?

ASC1-2 **Cross-Reference** The rules defining the conditions to classify an item as extraordinary on the income statement were originally listed in *APB Opinion No 30*, paragraph 20. Where is this information located in the Codification?

ASC1-3 **Disclosure** Suppose a firm entered into a capital lease (or a right-of-use asset), debiting an asset account and crediting a lease liability account for $150,000. Does this transaction need to be disclosed as part of the statement of cash flows? If so, where?

ASC1-4 **General** Principles Accounting textbooks under the former GAAP hierarchy were considered level 4 authoritative. Where do accounting textbooks stand in the Codification?

ASC1-5 **Presentation** How many years of comparative financial statements are required under current GAAP?

ASC1-6 **Overview** Can the provisions of the Codification be ignored if the item is immaterial?

2

ACCOUNTING FOR BUSINESS COMBINATIONS

CHAPTER CONTENTS

LEARNING OBJECTIVES

1. Describe the major changes in the accounting for business combinations since 2001, and the reasons for those changes.
2. Discuss the goodwill impairment test, including its frequency, the steps laid out in the new standard, and some of the implementation problems.
3. Explain how acquisition-related expenses are reported.
4. Describe the valuation of assets, including goodwill, and liabilities acquired in a business combination accounted for by the acquisition method.
5. Explain how contingent consideration affects the valuation of assets acquired in a business combination accounted for by the acquisition method.
6. Describe a leveraged buyout.
7. Describe the disclosure requirements according to current GAAP related to each business combination that takes place during a given year.

2.1 ACCOUNTING STANDARDS ON BUSINESS COMBINATIONS: BACKGROUND

LO 1 FASB's two major changes for business combinations.

FASB shook up the accounting community in the area of business combinations in December of 2007 by releasing two standards. The first, ***SFAS No. 141R***, "Business Combinations," completely replaced ***FASB Statement No. 141***. This pronouncement supports the use of a single method in accounting for business combinations, and uses the term "acquisition method" in place of the previous term, "purchase method," to describe the preferred approach. These standards are now codified in FASB ASC topic 805 [Business Combinations].

IFRS

Earlier in 2002 the two principal standard setting boards, the FASB and the IASB (International Accounting Standards Board), agreed to reconsider accounting for

business combination with the objective of convergence, or finding a common and comprehensive standard that could be used both domestically and in cross-border situations. Nonetheless, the subsequent acquisition standards are not identical and we describe some of the differences at the end of this chapter.

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

IN THE NEWS

The amendment to business combinations, put forward jointly by the International Accounting Standards Board (IASB) and U.S. Financial Accounting Standards Board (FASB), has its share of opponents. Various parties, including companies, analysts, accountants and regulatory bodies, tried to block the change, which they claimed was an effort by the standard setters to implement new rules rather than fine-tune the existing ones. The new standard places emphasis on fair values in a business combination, even in cases where less than 100% of the equity interests in the acquiree are purchased. Opponents state that the outcome of placing more goodwill on a company's financial statement is to produce artificial figures that fail to reflect the true value of a takeover transaction.[1]

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

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

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

CHANGES IN GAAP/ASC TOPIC 805 WITH SIGNIFICANT IMPLICATIONS FOR DEALS

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

RELATED CONCEPTS

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

LO 2 FASB's two major changes of 2001.

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

In June of 2001, **the Board prohibited the use of the pooling of interests method and decided that goodwill would no longer be amortized and would instead be tested periodically for impairment in a manner different from other assets**. Specifically, use of the pooling method has been prohibited for business combinations initiated since June 30, 2001. Furthermore, goodwill acquired in a business combination completed since June 30, 2001, should not be amortized.[2]

Initially after this standard was issued, some companies' management and even analysts responded with rosy predictions that the earnings numbers would look

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

a lot ***better*** for companies with large amounts of goodwill, less than a year later many of these same firms were writing off large chunks of goodwill under the impairment rules. Today all mergers in the United States are accounted for by the acquisition method.

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

Goodwill Impairment Tests – Former Standards

RELATED CONCEPTS

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

As might be predicted, responses to the changes ranged from complaints that the FASB had "given away the store"[3] to praise that the combined changes would yield enhanced flexibility for businesses.

Others, such as Morgan Stanley Dean Witter's Trevor Harris, argued from the onset that there should be no long-term effect on stock prices and that any initial price effect from the changed accounting standards was merely a momentum play.[4]

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

A portion of auditors' testimony in the case against former Enron Corp. Chairman Kenneth Lay focused on the "alleged downward manipulation of charges for goodwill expenses." Prosecutors argued that Mr. Lay misled the company's auditors in October 2001 regarding Enron's plans for a water-distribution unit in order to avoid big charges to earnings. The accounting rules introduced in 2001 require a company to write-down an asset if it doesn't meet certain standards, which in the water-distribution's case included whether the company had a costly growth plan. Without such a plan, Enron would have been forced to recognize impairment in an amount in the hundreds of millions of dollars. At the time of the audit, Lay claimed the company planned to spend over $1 billion on the unit; this statement contradicted earlier claims that the company was going to sell the water operation, a non-core business.[5]

FASB recognized the possible impact of the standard on earnings volatility in the following statements: Because goodwill and some intangible assets are no longer amortized, the reported amounts of goodwill and intangible assets (as well as total assets) do not decrease at the same time and in the same manner as under previous standards. There may be more volatility in reported income than under previous standards because impairment losses are likely to occur irregularly and in varying amounts.

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

[4] *Duff and Phelps, 2017 Goodwill Impairment Study*.

[5] *WSJ*, "Enron Former Auditors Testify on Charges, Reserve Accounts," by Gary McWilliams and John R. Emshwiller, 3/21/06, p. C3.

2.2 ILLUSTRATION OF ACQUISITION ACCOUNTING

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

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

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

Identifiable assets acquired (including intangibles other than goodwill) and liabilities assumed should be recorded at their fair values at the date of acquisition. Any excess of total cost over the sum of amounts assigned to identifiable assets and liabilities is recorded as goodwill. FASB believes that goodwill can't be measured directly and is a residual amount. Goodwill should not be amortized but should be adjusted downward only when it is "impaired" as described in the following section.

LO 6 Valuation of acquired assets and liabilities assumed.

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

When the net amount of the fair values of identifiable assets less liabilities ***exceeds the total cost*** of the acquired company, the acquisition is sometimes referred to as a **bargain**. When a bargain acquisition occurs, gain must be recognized to balance the accounts. Because of its reluctance to recognize income in a purchase or acquisition (where the usual facets of revenue recognition are absent), the FASB had, *in the past*, required that most long-lived assets be written down on a pro rata basis in such

IN THE NEWS

St. Jude Medical, Inc. announced that it will acquire Irvine Biomedical, Inc. (IBI), an Irvine, California-based company that develops electrophysiology (EP) catheter products used by physician specialists to diagnose and treat cardiac rhythm disorders. St. Jude foresees recording an in-process R&D charge of $8 to $10 million at closing in connection with this acquisition. Apart from this in-process R&D charge, the transaction will not impact St. Jude's existing EPS guidance for 2004.[6]

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

a situation before recognizing any gain. If the initial measurement of an acquisition results in a bargain purchase, FASB ASC paragraph 805-30-25-4 requires the acquirer ***to reassess*** whether it has correctly identified all of the assets acquired and all of the liabilities assumed ***before*** recognizing a gain on a bargain purchase. As part of the required reassessment, the acquirer needs to review the procedures used to measure the amounts recognized at the acquisition date. It does not, however, require that any asset be marked down *below* its fair value. Once that determination is established, then **the excess of acquisition-date fair value of net assets over the consideration paid is recognized in income (the bargain purchase gain).**

Acquisition Example Assume that on January 1, 2020, P Company, in a merger, ***acquired the assets*** and assumed the liabilities of S Company. P Company gave one of its $15 par value common shares to the former stockholders of S Company for every two shares of the $5 par value common stock they held. Throughout this text, the company names P and S are frequently used to distinguish a parent company from a subsidiary. In an asset acquisition, these terms are inappropriate because the books of the acquired firm are dissolved at the time of acquisition. Nonetheless, the distinction is useful to avoid confusion between the acquirer and the acquired.

P Company common stock, which was selling at a range of $50 to $52 per share during an extended period prior to the combination, is considered to have a fair value per share of $48 after an appropriate reduction is made in its market value for additional shares issued and for issue costs. The total value of the stock issued is $1,440,000 ($48 × 30,000 shares). Balance sheets for P and S companies (along with relevant fair value data) on January 1, 2020, are presented in Illustration 2-1. Because the book value of the bonds is $400,000, bond discount in the amount of $50,000 ($400,000 − $350,000) must be recorded to reduce the bonds payable to their present value.

ILLUSTRATION 2-1

Balance Sheets of P and S Companies January 1, 2020

	P Company	*S Company*	
	Book Value	*Book Value*	*Fair Value*
Cash and receivables	$ 250,000	$ 180,000	$ 170,000
Inventories	260,000	100,000	140,000
Land	600,000	120,000	400,000
Buildings & equipment	800,000	900,000	1,000,000
Accumulated depreciation—buildings & equipment	(300,000)	(300,000)	
Total assets	$ 1,610,000	$1,000,000	$1,710,000
Current liabilities	$ 110,000	$ 110,000	$ 150,000
Bonds payable, 9%, due 1/1/2021, interest payable semiannually on 6/30 and 12/31*	—0—	400,000	350,000
Total liabilities	$ 110,000	$ 510,000	$ 500,000
Stockholders' Equity			
Common stock, $15 par value, 50,000 shares	750,000		
Common stock, $5 par value, 60,000 shares		300,000	
Other contributed capital	400,000	50,000	
Retained earnings	350,000	140,000	
Total Stockholders' equity	1,500,000	490,000	
Total liabilities and stockholders' equity	$ 1,610,000	$1,000,000	
Net assets at book value (Assets minus liabilities)	$ 1,500,000	$ 490,000	
Net assets at fair value			$1,210,000

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

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

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

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

After the merger, S Company ceases to exist as a separate legal entity. Note that under the acquisition method the cost of the net assets is measured by the fair value (30,000 shares × $48 = $1,440,000) of the shares given in exchange. Common stock is credited for the par value of the shares issued, with the remainder credited to other contributed capital. Individual assets acquired and liabilities assumed are recorded at their fair values. Plant assets are recorded at their fair values in their current depreciated state (without an initial balance in accumulated depreciation), the customary procedure for recording the purchase of new or used assets. Bonds payable are recorded at their fair value by recognizing a premium or a discount on the bonds. After all assets and liabilities have been recorded at their fair values, an excess of cost over fair value of $230,000 remains and is recorded as goodwill. The amount of goodwill is always the residual in these computations.

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

ILLUSTRATION 2-2

P Company Balance Sheet after Acquisition, January 1, 2020

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

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

Treatment of Acquisition-Related Expenses

Under FASB ASC paragraph 805–10–25–23, acquisition-related costs are excluded from the measurement of the consideration paid, because such costs are not part of the fair value of the acquiree and are not assets. This is a change from past GAAP where the purchase method required only indirect costs to be expensed, while direct costs were capitalized as part of the purchase price. ***Direct expenses*** *incurred in the combination include finder's fees, as well as advisory, legal, accounting, valuation, and other professional or consulting fees.* ***Indirect****, ongoing costs include the cost to maintain a mergers and acquisitions department, as well as other general administrative costs such as managerial or secretarial time and overhead that are allocated to the merger but would have existed in its absence*. Both direct and indirect costs are expensed, and the cost of issuing securities is also excluded from the consideration and accounted for separately from the business combination accounting. Expected restructuring costs (with no obligation at the acquisition date) are also accounted for separately from the business combination. In the absence of more explicit guidance, we assume that ***security issuance costs*** are *assigned to the valuation of the security*, thus reducing the additional contributed capital for stock issues or adjusting the premium or discount on bond issues.

LO 4 Reporting acquisition expenses.

Acquisition Costs—an Illustration Suppose that SMC Company acquires 100% of the net assets of Bee Company (net book value of $100,000) by issuing shares of common stock with a fair value of $120,000. With respect to the merger, SMC incurred $1,500 of accounting and consulting costs and $3,000 of stock issue costs. SMC maintains a mergers department that incurred a monthly cost of $2,000. The following illustrates how these direct and indirect merger costs and the security issue costs are recorded.

Professional Fees Expense (Direct)	1,500	
Merger Department Expense (Indirect)	2,000	
Other Contributed Capital (Security Issue Costs)*	3,000	
Cash		6,500

*FASB ASC paragraph 805-10-25-23 states that the costs to issue debt or equity securities shall be recognized in accordance with other applicable GAAP.

Income Tax Consequences in Business Combinations

The fair values of specific assets acquired and liabilities assumed in a business combination may differ from the income tax bases of those items. A deferred tax asset or liability should be recognized for differences between the assigned values and tax bases of the assets and liabilities recognized in a business combination. The treatment of income tax consequences is addressed in Appendix 2A, which is available at www.wiley.com/go/jeter/AdvancedAccounting7e.

2.3 BARGAIN PURCHASE ACCOUNTING ILLUSTRATION (PURCHASE PRICE BELOW FAIR VALUE OF IDENTIFIABLE NET ASSETS)

IN THE NEWS

Chicago-based Abbott Laboratories completed its $4.1 billion cash acquisition of Guidant Corp.'s vascular-device business. Abbott originally agreed to the purchase during the bidding war between Johnson & Johnson and Boston Scientific over cardiac-device maker Guidant. Abbott's vascular operations generated just $253 million in revenues in 2005 while Guidant's had more than $1 billion in 2005. Abbott said it expects the combined vascular group to have revenue of $3 billion in 2006. Experts consider Abbott to have obtained a solid bargain in its purchase.[7]

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

- Any previously recorded goodwill on the seller's books is eliminated (and no new goodwill recorded).
- A **gain** is reflected in current earnings of the acquiree to the extent that the fair value of net assets exceeds the consideration paid.[8]
- Acquirers are required to reassess whether it has correctly identified all of the assets acquired and liabilities assumed (including intangibles) before recognizing a gain.

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

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

RELATED CONCEPTS

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

A bargain gain of $6,000 must be recorded upon acquisition because the cost of the acquisition ($17,000) is less than the fair value of net assets acquired ($23,000).

The entry by Payless Company to record the acquisition is (recall that the assets and liabilities must be recorded at fair value):

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

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

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

2.4 MEASUREMENT PERIOD AND MEASUREMENT PERIOD ADJUSTMENTS

Because the FASB requires that the identifiable net assets be recorded at fair value in an acquisition, the amounts reported as fair value in the financial statements may be preliminary (and the estimates may not yet be final). If the fair value estimates are not complete, they are referred to as 'provisional' amounts. Acquirers are given one year to finalize these estimates. This one-year period is referred to as the measurement period. During the measurement period the acquirer may adjust the provisional amounts recognized for a business combination. The measurement period provides the acquirer with a reasonable time to obtain the information necessary to identify and measure any of the following as of the acquisition date:

a. The identifiable assets acquired, liabilities assumed, and any noncontrolling interest in the acquiree

b. Any consideration transferred to the acquiree

c. In a business combination achieved in stages, any previous equity interest held by the acquirer

d. The amount recognized as goodwill or the gain from a bargain purchase

Prior rules for measurement period adjustment required retrospectively adjusting all provisional amounts. Current GAAP requires that the financial statements be adjusted in the period the measurement period adjustment is resolved. Firms can no longer wait to adjust the books (nor are they allowed to restate items), they must be adjusted immediately.

During the measurement period, the acquirer recognizes additional assets or liabilities as new information is obtained about facts and circumstances that existed at the acquisition date which, if known, would have resulted in the recognition of those assets and liabilities. The ***measurement period ends*** as soon as the acquirer receives the information it was seeking about facts and circumstances that existed at the acquisition date, or learns that more information is not obtainable. However, ***the measurement period shall not exceed one year*** from the acquisition date. Thus measurement period adjustments are not the result of "new" information learned "after" the date of acquisition. Measurement period adjustments reflect information at the date of acquisition.

The acquirer recognizes an increase (decrease) in the provisional amount recognized for an identifiable asset (liability) by means of a decrease (increase) in goodwill. During the measurement period, the acquirer should recognize adjustments to the provisional amounts as if the accounting for the business combination had been completed at the acquisition date. Further, the acquirer should revise comparative information for prior periods presented in financial statements if needed, including changes in depreciation, amortization, or other income effects recognized in completing the initial accounting.

After the measurement period ends, the acquirer only revises the accounting for a business combination to correct an error.

IN THE NEWS

The top 6 Goodwill Impairments reported in 2016*

1. Baker Huges, $1.9 Billion
2. Community Health Services, $1.6 billion
3. Energy Transfer Equity, LP, $1.3 billion
4. National Oilwell Varco, Inc. $972 million
5. The Priceline Group, Inc. $941 million
6. Xerox Corporation, $935.

- Duff & Phelps, 2017 U.S. Goodwill Impairment Study

2.5 GOODWILL IMPAIRMENT TEST

LO 3 Goodwill impairment assessment.

For **public companies**, goodwill is no longer amortized on the income statement. Instead, goodwill of each reporting unit is tested for impairment on an annual basis. The annual goodwill impairment test may be performed any time during the fiscal year, provided the test is performed at the same time every year. Different reporting units may be tested for impairment at different times.

In January 2014, FASB amended the standard for **private companies**, allowing them to elect an alternative model. Under this alternative, goodwill is amortized over a period not to exceed 10 years, and a simplified impairment model is used.

In 2017, FASB simplified the test for goodwill impairment for public companies. FASB eliminated the two-step approach. The new approach should reduce costs needed to measure goodwill impairment. The new test is also a two-part test. These parts are labeled *qualitative* and *quantitative* assessments also, early adoption is permitted.

Because **public companies** assign goodwill to a reporting unit, they first assess *qualitative* factors to determine whether it is more likely than not that the fair value of the reporting unit is less than its carrying amount. Qualitative factors include items such as general economic conditions, increased competitive environment, declining cash flows, etc. If the assessment of the qualitative factors indicate that it is more likely than not (a likelihood greater than 50%) that the fair value of the reporting unit is less than its carrying amount (with goodwill), the entity performs the *quantitative* test to determine the amount of impairment.

In *this step*, if the carrying amount of a reporting unit is greater than its fair value, goodwill of the reporting unit is considered impaired. The amount of goodwill impairment is the lower of a) the carrying value of goodwill or b) the excess of the carrying amount of the reportable unit (including goodwill) over its fair value. See Illustration 2-3 for a visual illustration of this process.

IN THE NEWS

What is a reporting unit? A reporting unit is the level at which management reviews and assesses the operating segment's performance—in other words, discrete business lines or units that can be grouped by geography and can produce stand-alone financial statements (for example, four operating divisions reporting to the corporate parent). A company can use a reporting unit one level below the operating segment for impairment testing if components of an operating segment engage in business activities for which discrete financial information is available, have economic characteristics different from the other components of the operating segments, and are at the level at which goodwill benefits are realized. Duff & Phelps report that of all public companies in their sample, 16% reported one reportable unit, 47% reported between 2 to 5 reportable units, 25% reported between 6 to 10 reportable units, and 11% reported more than 10 reportable units. In addition, they report that 37% of public companies report goodwill and that 9% of these companies reported goodwill impairment in 2016.

IN THE NEWS

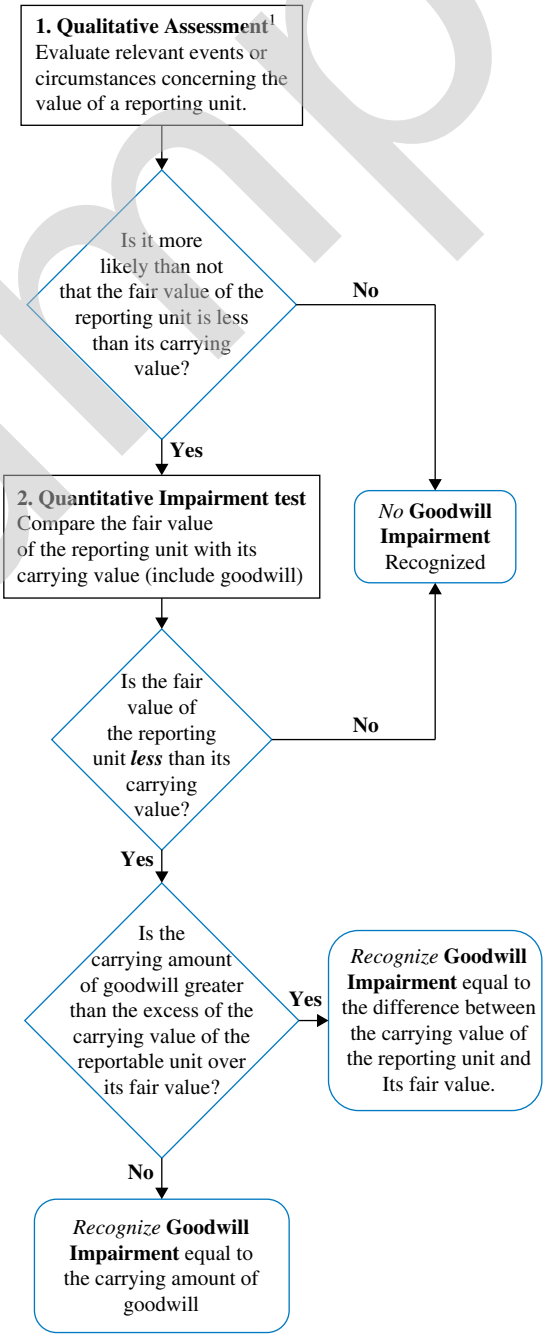
The number of goodwill impairments dropped from 350 events in 2015 to 288 events in 2016. The total dollar amount of the goodwill impairment, also dropped, from $59.9 billion to $28.5 billion.

Illustration of Determining Goodwill Impairment

In the qualitative assessment, the entity assesses qualitative factors to determine if it is *more likely than not* that the fair value of the reporting unit is below its book value. If it is, then in the company performs the quantitative test in determining whether the value of impaired goodwill. Firms have an unconditional option to skip the qualitative test and move directly to the quantitative test. Assume:

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

ILLUSTRATION 2-3 Annual Goodwill Impairment Tests (effective 12-16-2019)

Theory	Example
	**Example**: *Date of acquisition* Suppose the identifiable net assets of S Company (a reportable unit) are $350,000 and goodwill is $100,000. **Year of testing**: *Qualitative Assessment*: Because of deteriorating economic conditions and increases in raw materials prices, it is judged more likely than not that, the fair value is less than carrying value of the reportable unit. *Quantitative Assessment*: The carrying value of S Company is $410,000 (including goodwill of $100,000). The fair value of S Company is $400,000. Because the carrying value is greater than the fair value, goodwill is impaired. *Goodwill Impairment amount*: Goodwill impairment is the *lower of*: a. Carrying value of goodwill, $100,000, b. Excess of carrying value (including goodwill) over fair value of S Company, or $410,000 less $400,000 = $10,000. *Goodwill Impairment amount*: Goodwill impairment is $10,000

[1]An entity has an unconditional option to skip the qualitative test and move directly to the quantitative test and compare the fair value of the reportable unit with its carrying value (including goodwill).

RELATED CONCEPTS

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

On the first periodic review date:

The qualitative test determines if there is a potential impairment. If it is judged more likely than not that impairment exists, the company moves to the quantitative test. The quantitative test determines the amount of goodwill impairment, if any. If the carrying value of the reporting unit (including goodwill) is larger than the fair value of the reporting unit, goodwill impairment exits. If the carrying value is less than the fair value no impairment is considered.

Quantitative Test	
Fair value of the reporting unit	$400,000
Carrying value of reporting unit (includes goodwill)	410,000
Excess of carrying value over fair value (if negative, impairment exits)	($10,000)

Since the carrying value of the reporting unit is larger than $400,000 by $10,000, the amount of goodwill impairment is the lower of: 1) the excess of the carrying value over fair value ($10,000), or 2) the carrying value of existing goodwill ($100,000). Since the excess is less than the carrying value of goodwill, the amount of goodwill impairment is $10,000.

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

If an impairment test for goodwill occurs at the same time as an impairment test for any other asset, the FASB instructs that the other asset should be tested for impairment first. FASB also specifies that intangible assets other than goodwill should be amortized over their useful lives (if finite lives exist) and reviewed for impairment in accordance with FASB **ASC 350–30–35–17, 18.**

IN THE NEWS

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

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

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

RELATED CONCEPTS

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

Disclosures Mandated by FASB

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

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

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

a. The aggregate amount of goodwill should be a separate line item in the balance sheet.

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

Other Required Disclosures

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

LO 9 New disclosure requirements for business combinations.

- The name and a description of the acquiree.
- The acquisition date.
- The percentage of voting equity instruments acquired.
- The primary reasons for the business combination, including a description of the factors that contributed to the recognition of goodwill.
- The fair value of the acquiree and the basis for measuring that value on the acquisition date.
- The fair value of the consideration transferred, including the fair value of each major class of consideration.
- The amounts recognized at the acquisition date for each major class of assets acquired and liabilities assumed in the form of a condensed balance sheet.
- The maximum potential amount of future payments the acquirer could be required to make under the terms of the acquisition agreement.

TEST YOUR KNOWLEDGE **2.1**

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

Multiple Choice

1. Which of the following statements is *true* with respect to the accounting for business combinations under U.S. GAAP?
   a. Incomparability of financial statements under the previous rules permitting two distinct methods of accounting for business combinations (purchase and pooling) was corrected by making amortization of goodwill optional.
   b. Under the current standards, impairment of goodwill is not accounted for because it does not affect the actual profit of the company.
   c. The acquired business should be recognized at its fair value on the acquisition date, regardless of whether the acquirer purchases all or only a controlling percentage.
   d. Any goodwill acquired in previous acquisitions should continue to be amortized after the year 2001 for the continuity of the accounting practice.
2. Goodwill impairment exists only if the fair value of the business unit:
   a. Equals the carrying value of the reporting unit (including goodwill).
   b. Is greater than the carrying value of the reporting unit (including goodwill).
   c. Is less than the carrying value of the reporting unit (including goodwill).
   d. None of the above.

3. Which of the following is *incorrect?*
   a. Under acquisition accounting, direct acquisition costs are recorded by decreasing goodwill as a contra account.
   b. Under acquisition method accounting, indirect acquisition costs (such as expenses incurred by a firm's permanent M&A department) are expensed.
   c. Security issue costs, such as brokerage fees, reduce the Excess Paid In Capital account (i.e., are recorded as a debit to that account).
   d. Accounting and consulting fees incurred in a business combination are expenses under the current standards for acquisitions.

2.6 CONTINGENT CONSIDERATION (EARNOUTS)

LO 7 Contingent consideration and valuation of assets.

In some acquisitions, the buyer and the seller have trouble agreeing on the purchase price. For instance, the seller might hold more optimistic views on the future performance of the target than the purchaser does. In these cases, the purchase agreement sometimes provide that the purchasing company will pay more to the seller if certain specified future events or transactions occur (such as if revenues and/or earnings exceed some future threshold). The contingency may require the payment of cash (or other assets) or the issuance of additional securities. Between 2001 and 2017, approximately 7.8% of public acquirers used contingent consideration as a means of consideration in an acquisition. GAAP requires that all contractual contingencies, as well as non-contractual liabilities for which it is **more likely than not** that an asset or liability exists, be measured and recognized at fair value on the acquisition date.[9] This includes contingencies based on earnings, (often referred to as earnouts) guarantees of future security prices, and contingent payouts based on the outcome of a lawsuit. For example, if the acquirer agrees to transfer additional equity interests, cash or other assets to the former owners of the acquiree at some future date if *specified targets are met*, the acquirer should measure and recognize the fair value of the *contingent consideration* as of the acquisition date. That consideration is classified as either debt or equity on the basis of other generally accepted accounted principles.

SFAS No. 141R (FASB ASC Topic 805 Business Combinations) changed the accounting for earnouts both on the measurement date and on subsequent dates (potential remeasurement of related liabilities or assets). In an earnout, for instance, the acquiring firm might agree to pay additional cash if the revenue of the acquired firm exceeds some specified future amount. Alternatively, future payments might be based upon gross margin, or earnings targets, or contingent upon the achievement of certain milestones such as regulatory approval of a drug. If there is *significant uncertainty* surrounding the future performance of a target, the acquiring firm often includes earnouts as part of the consideration paid to help mitigate the risk of overpayment. Since 2010, public acquirers in the United States have used earnouts in approximately 9% of all acquisitions.

SFAS No. 141R requires the acquirer to recognize contingent consideration and to measure the fair value of the consideration at the acquisition date. Typically, these are level 3 fair value liabilities.[10] Under the prior FASB standard, contingent consideration obligations usually were not recognized at the acquisition date, and were typically only recognized when the contingency was resolved and consideration was issued or became issuable.

[9] "Otherwise, non-contractual liabilities are recorded under other applicable GAAP (see FASB ASC Topic 450 Contingencies)."

[10] Level 3 obligations are obligations that cannot be determined using observable inputs, such as market prices. Fair values of these obligations require estimates.

The classification of contingent consideration as a liability or equity is based on FASB ASC Topic 480, Distinguishing Liabilities from Equity. An arrangement will generally be classified as a liability if it is settled with a variable number of a buyer's equity shares and creates

1. a fixed obligation known at inception,
2. an obligation, the amount of which varies inversely with changes in the fair value of the buyer's equity shares, or
3. an obligation, the amount of which varies based on something other than the fair value of the buyer's equity shares.

Equity classification generally requires that a fixed number of shares be paid and that the performance target be based on the operations of the acquirer or acquiree (and not on an external index).

Examples of equity shares used in contingent consideration that would be treated as a liability include: (1) the acquirer is required to issue additional shares if the acquirer's share price drops below a certain price after a year; (2) the acquirer's obligation is based on something other than the acquirer's operations, such as the S&P 500 index or oil price futures; and (3) the number of contingent shares changes based on different levels of the acquirer's or target's revenue. The FASB decided that obligations for contingent consideration classified as equity should not be remeasured after the acquisition date. More than 95% of contingent consideration contracts are classified as liabilities (rather than as equity).

The fair value of the contingent consideration (if classified as a liability) is remeasured each fiscal quarter with the resulting **change in fair value reported as a gain or a loss in operating income**. If the earnout is to be paid in stock (and the stock qualifies for equity classification), the changes in fair value are **never recognized** in income; once the earnout is resolved, any adjustment is made to equity.

The adjustment to fair value for contingent consideration classified as a liability is counterintuitive in the following sense. If the likelihood of an earnout payment increases because the likelihood of meeting the performance targets increases, a loss is recorded (this creates a larger liability because larger future cash payments are expected). The counterintuitive aspect is that this situation implies favorable performance by the target. On the other hand, if the likelihood of an earnout payment decreases, a gain is recorded. Thus if the target's performance is poor, a gain is likely to be recorded. To complicate the interpretation further, we note that the change in the liability may be offset against a change in value of the assets, with a concomitant offsetting in the income statement. For instance, if a fair value gain on contingent consideration is recorded because of poor performance, this might be offset by a loss on impairment of goodwill or other assets.

Since the issuance of *SFAS No.141R*, if contingent consideration is used in a deal, it is approximately 34% of total deal value. Cadman, Carrizosa, and Faurel (2011)[11] report that 46% of the *maximum* potential earnout value, on average, is recorded on the books of the acquirer on the date of acquisition as the fair value of the contingent consideration. Thus a significant amount of debt is added to the books when the acquisition includes contingent consideration because most contingent consideration is classified as a liability rather than as equity.

[11] Cadman, B., R. Carrizosa, and L. Faurel, The Information Content and Contracting Consequences of SFAS 141(R): the Case of Earnout Provisions, 2012.

Potential methods for estimating the fair value of contingent consideration are quite varied. The income approach, for instance, involves estimating expected cash flows under various scenarios and discounting these using some appropriate discount rate and levels of probability for each.

Contingent consideration classified as a liability: Assume that P Company acquired all the net assets of S Company (current assets of $20,000, buildings for $400,000, and liabilities of $50,000 for cash of $510,000). P Company also agreed to pay:

1. an additional $150,000 to the former stockholders of S Company if the post combination revenues over the next two years equaled or exceeded $800,000 and
2. an additional $200,000 if the revenues exceeded $1,000,000. The fair value of the contingent consideration was estimated to be $60,000 (based on the expected present value of future cash flows). P Company will make the following entry on the date of acquisition:

Current assets	20,000	
Buildings	400,000	
Goodwill	200,000	
Liabilities		50,000
Contingent consideration		60,000
Cash		510,000

Since the contingent consideration is to be settled with cash, it is classified as a liability, P Company must remeasure the contingent consideration each quarter and recognize the change in fair value in income.

If by the end of the first year, the likelihood has increased that the revenue target will be met, P Company should assess an increase in the fair value of the contingent consideration. If the fair value at the end of year one increased to $100,000, P Company would make the following entry:

Increase in Liability:		
Loss from contingent consideration	40,000	
Contingent Consideration		40,000

If on the other hand, it has become unlikely that either target will be met, P Company should remove the liability altogether, and would make the following entry:

Decrease in Liability:		
Contingent Consideration	60,000	
Gain from contingent consideration		60,000

Any cash paid to settle a contingent consideration claim is classified on the statement of cash flows as follows: Any cash paid up to the original amount of the fair value of contingent consideration recorded on the date of acquisition, is classified as a cash from investing financing cash flow. Any excess cash paid is classified as an operating cash flows. In the example, the first $60,000 of cash paid would be classified as an investing cash flow and any cash paid over the $60,000 would be classified as operating. Any cash paid soon after the date of acquisition (within 3 months) would be classified as cash from investing.

Contingent consideration classified as equity: In the previous example, even if the contingent consideration were to be paid in common shares, the contingent consideration would be classified as a liability because the number of shares needed to satisfy the obligation is variable.[12]

Suppose that in the previous example, P Company agreed to issue an additional 10,000 shares of $1 par value common stock to the former stockholders of S Company if the post-combination revenues over the next two years equaled or exceeded $800,000. The fair value of the contingent consideration was estimated to be $40,000. P Company should make the following entry on the date of acquisition:

Current assets	20,000	
Buildings	400,000	
Goodwill	180,000	
Liabilities		50,000
Paid in capital contingent consideration		40,000
Cash		510,000

P Company would not remeasure the paid in capital balance based on changes in the fair value of the common stock. Suppose that the contingent consideration was paid. P Company would make the following entry:

Consideration is paid:		
Paid in capital contingent consideration	40,000	
Common stock (10,000 shares at $1 par)		10,000
Paid in capital—common stock		30,000

If on the other hand, it became unlikely that the target would be met, P Company would make the following entry:

Consideration is not paid:		
Paid in capital contingent consideration	40,000	
Paid in capital—from unsatisfied targets		40,000

Approximately 90% of earnout contracts are based on the performance of the acquired firm, while 9% are based on the performance of the combined firm. One percent of earnouts are not directly related to either and might be based on other indices such as oil futures. When the earnout is based on the performance of the acquired firm, approximately 60% of these are based on revenue and 26% are based on achieving milestones (patent approval). Very few are actually based on earnings.

Although earnouts may be helpful in getting past negotiating obstacles and possibly in reducing up-front payouts for buyers, they suffer from drawbacks in implementation. In particular, they are very difficult to administer and may trigger post-deal conflicts between buyers and sellers. Their primary niche is in the acquisition of private companies where management retention is a key issue. Between 2001 and 2017, earnouts were used in 10% of acquisitions when a public company acquired a private company, but earnounts were used in only 4% of acquisitions when a public company acquired another public company. Other places where they are used include cross-border deals and deals where corporate sellers wish to maintain a share in future performance.

[12] If shares are issued to satisfy contingent consideration, a variable number of shares can be issued and still meet the equity classification if the settlement amount *varies directly with the acquirer's equity share price* (considered an input used to determine the fair value of a fixed option arrangement).

Earnouts are more significant in service-related industries and high-growth and high-tech industries. The average earnout period is around 3.6 years with approximately 18% of earnouts extending over five years. Illustration 2-4 summarizes recent trends related to the use of contingent payments.

ILLUSTRATION 2-4

Deals Reporting the Amount of Contingent Consideration (Earnouts) Public Acquirers 2001 To 2017 ($ Millions)

Panel A: Percentage of Deals With Earnouts and Earnouts as a Percentage of Deal Value

	Percentage of Deals with Earnouts	*Earnout as a Percent of Deal Value*
2001	5.7%	34.8%
2002	6.9%	35.2%
2003	7.5%	32.0%
2004	7.6%	32.7%
2005	6.6%	31.0%
2006	7.8%	30.3%
2007	8.3%	31.4%
2008	10.2%	34.8%
2009	8.7%	36.1%
2010	8.3%	36.6%
2011	9.5%	36.2%
2012	8.0%	31.3%
2013	7.7%	35.3%
2014	7.8%	33.2%
2015	7.7%	32.9%
2016	7.2%	31.3%
2017	7.1%	30.4%
Average	7.8%	33.3%

Panel B:

	Deal Value			
	No Earnout		*With Earnout*	
	Number	*Value*	*Number*	*Value*
2001	1,005	477.7	61	124.7
2002	1,426	169.4	105	58.7
2003	1,365	228.1	111	152.9
2004	1,612	268.1	132	88.2
2005	1,747	366.1	124	105.6
2006	1,690	367.5	143	121.2
2007	1,617	329.0	147	102.6
2008	1,111	289.6	126	153.2
2009	845	564.8	80	188.6
2010	1,073	321.4	97	162.3
2011	1,071	409.5	113	128.7
2012	1,155	332.9	101	260.1
2013	1,096	367.2	92	198.3
2014	1,308	602.2	111	210.3
2015	1,142	796.3	96	205.4
2016	898	632.8	70	504.8
2017	799	394.6	61	293.1

Source: *Thomson SDC Platinum*.

2.7 PRO FORMA STATEMENTS AND DISCLOSURE REQUIREMENT

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

LO 5 Use of pro forma statements.

First, pro forma statements are often prepared before the fact for combinations under consideration. When management is contemplating the purchase price offer, for example, a number of pro forma statements may be produced, using different assumed purchase prices and projecting one or more years into the future, or alternatively restating a past period as though the firms had been combined. After the boards of directors of the constituents have reached tentative agreement on a combination proposal, pro forma statements showing the effects of the proposal may be prepared for distribution to the stockholders of the constituents for their consideration prior to voting on the proposal. If the proposed combination involves the issue of new securities under *Securities and Exchange Commission (SEC)* rules, pro forma statements may be required as part of the registration statement.

When a pro forma statement is prepared, the tentative or hypothetical nature of the statement should be clearly indicated, generally by describing it as "pro forma" in the heading and including a description of the character of the transactions given effect to. Further description of any other adjustments should be clearly stated on the statement or in related notes. A pro forma balance sheet (based on data presented in Illustration 2-1) that might be prepared for use by the companies' stockholders is presented in Illustration 2-5. The normal procedure is to show the audited balance sheet

ILLUSTRATION 2-5

P Company Pro Forma Balance Sheet Giving Effect to Proposed Issue of Common Stock for All the Net Assets of S Company January 1, 2020

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

as of a given date, individual adjustments for the proposed transaction, and resulting account balances.

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

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

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

TEST YOUR KNOWLEDGE **2.2**

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

Multiple Choice

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

2.8 LEVERAGED BUYOUTS

LO 8 Leveraged buyouts.

IN THE NEWS

Kohlberg Kravis Roberts & Co. (KKR) agreed to purchase Flextronics Software Systems for $900 million, making the deal India's biggest leveraged buyout ever. Under the agreement, Singapore-based Flextronics International Ltd., the world's largest producer of electronics for other companies, will sell 85% of the unit to KKR. The investment in Flextronics Software surpasses General Electric Co.'s 2004 sale of its Indian call-center group to buyout firms General Atlantic Partners LLC and Oak Hill Capital Partners LP for $500 million.[13]

A *leveraged buyout (LBO)* occurs when a group of employees (generally a management group) and third-party investors create a new company to acquire all the outstanding common shares of their employer company. The management group contributes whatever stock they hold to the new corporation and borrows sufficient funds to acquire the remainder of the common stock. The old corporation is then merged into the new corporation. The LBO market rose dramatically from 2002 to 2007, as evidenced in Illustration 2-6, before dropping off in 2008 and 2009. In 2010, the number of leveraged buyouts increased by 53% over the number in 2009 and has continued to increase in numbers through 2012.

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

ILLUSTRATION 2-6

The Leveraged Buyout Market (LBO) 2002–2012

Year	*No. of Deals*	*% of all Deals*
2002	187	3.1%
2003	197	3.0%
2004	366	4.7%
2005	520	6.1%
2006	754	7.8%
2007	815	7.8%
2008	576	6.8%
2009	287	4.9%
2010	438	6.4%
2011	593	7.6%
2012	666	6.4%

Data Source: *Mergers and Acquisitions*, February 2009, 2010, 2011.

SUMMARY

1 *Describe the changes in the accounting for business combinations approved by the FASB in 2007, and the reasons for those changes.* Under FASB ASC 805, the fair values of all assets and liabilities on the acquisition date are reflected in the financial statements, even if control is obtained with less than 100% ownership and even if control is achieved in stages rather than all at once. The scope includes business combinations involving only mutual entities, those achieved by contract alone, and the initial consolidation of variable interest entities (VIEs).

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

SFAS No. 160 [ASC 810–10–45–15 and 16] establishes standards for the reporting of the noncontrolling interest when the acquirer obtains control without purchasing 100% of the acquiree.

2 *Describe the two major changes in the accounting for business combinations approved by the FASB in 2001, as well as the reasons for those changes*. Of the two methods of accounting historically used in the United States—***purchase*** (now called acquisition) and ***pooling of interests***—pooling is now prohibited. The goodwill often recorded under the acquisition method is no longer amortized but instead is reviewed periodically for impairment. The standard setters believe that virtually all business combinations are acquisitions and should be based on the fair values exchanged.

3 *Discuss the goodwill impairment test, including its frequency, the steps laid out in the standard, and some of the implementation problems.* At least once a year, qualitative factors are considered initially to assess the likelihood of goodwill impairment. If indicated, goodwill impairment for each reporting unit is tested quantitative test. In this test, the fair value of a reporting unit is compared to its carrying amount (goodwill included) at the date of the periodic review. If the fair value at the review date is less than the carrying amount, the difference is the amount of goodwill impairment (limited to the carrying value of goodwill). See Illustration 2-1 for an illustration of the goodwill impairment rules.

4 *Explain how acquisition expenses are reported.* Acquisition related costs are excluded from the measurement of the consideration paid. Current GAAP requires that both direct and indirect costs be expensed and that the cost of issuing securities be excluded from the consideration and accounted for separately.

5 *Describe the use of pro forma statements in business combinations.* Pro forma statements are prepared to show the effect of planned or contemplated transactions on the financial statements. Pro forma statements serve: (1) to provide information in the ***planning*** stages of the combination and (2) to ***disclose*** relevant information subsequent to the combination.

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

7 *Explain how contingent consideration affects the valuation of assets acquired in a business combination accounted for by the acquisition method.* On the date of the acquisition, the purchaser records the contingent consideration at its fair value as an adjustment to the original purchase transaction. Adjustments to provisional amounts may be made throughout the measurement period only if they reveal additional information about conditions that existed at the acquisition date. After the measurement date, subsequent adjustments for any contingent consideration recorded as a liability are recognized in the income statement; contingent consideration recorded as equity is not remeasured.

8 *Describe a leveraged buyout.* A leveraged buyout (LBO) occurs when a group of employees (generally a management group) and third-party investors create a new company to acquire all the outstanding common shares of their employer company. The LBO term results because most of the capital of the new corporation comes from borrowed funds.

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

Supplemental Appendix 2A, "Deferred Taxes in Business Combinations," is available from your instructor.

TEST YOUR KNOWLEDGE SOLUTIONS

2.1 1. c 2. c 3. a *2.2* 1. c 2. d 3. a

QUESTIONS

(The letter A after a question, exercise, or problem means that the question, exercise, or problem relates to Chapter Appendix 2A.)

LO 7 **1.** When contingent consideration in an acquisition is based on the acquirer issuing its shares to the seller, how should this contingency be reflected on the acquisition date?

LO 5 **2.** What are pro forma financial statements? What is their purpose?

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

LO 3 **4.** AOL announced that because of an accounting change (*FASB Statements Nos. 141R* [ASC 805] *and 142* [ASC 350]), earnings would be increasing over the next 25 years by $5.9 billion a year. What change(s) required by FASB (in *SFAS Nos. 141R and 142*) resulted in an increase in AOL's income? Would you expect this increase in earnings to have a positive impact on AOL's stock price? Why or why not?

Business Ethics

There have been several cases of a CEO or CFO resigning or being ousted for misrepresenting academic credentials. For instance, during February 2006, the CEO of RadioShack resigned by "mutual agreement" for inflating his educational background. During 2002, Veritas Software Corporation's CFO resigned after claiming to have an MBA from Stanford University. On the other hand, Bausch & Lomb Inc.'s board refused the CEO's offer to resign following a questionable claim to have an MBA.

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

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

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

ANALYZING FINANCIAL STATEMENTS

AFS2-1 **Tesla Acquires SolarCity (2016).**

On November 21, 2016, Tesla acquired SolarCity by issuing stock valued at $2.146 billion dollars. Tesla issued 11,124,497 shares of 0.001 par value common stock.

On the date of acquisition, the allocation of the purchase consideration was as follows (condensed) (dollars in thousands):

Assets acquired	
Cash	$ 213,523
Accounts Receivable	74,619
Inventory	91,878
Solar energy systems	5,781,496
Property, plant and equipment	1,056,312
Intangible assets	356,510
Prepaid expenses	199,864
Other	638,908
	8,513,110
Liabilities Assumed	
Accounts payable	230,078
Accrued liabilities	238,590
Debt	3,525,130
Deferred revenues	271,128
Other	950,423
	5,215,349
Noncontrolling interests (not acquired)	1,063,057
Net Assets Acquired	2,234,704
Bargain gain	88,727
Total Purchase Price	$2,145,977

Questions:

A. Assuming this were treated as an asset acquisition (business combination), prepare the journal entry on Tesla's books to record the acquisition.

B. Tesla disclosed the following concerning the bargain gain:

Gain on acquisition

The accounting guidance requires that a gain resulting from the fair value of acquired net assets being greater than the consideration paid to acquire the net assets be recorded as a gain included in the results of operations on the acquisition date. We recognized a gain on acquisition of $88.7 million in the fourth quarter of 2016, which is recorded in other income (expense), net on our Consolidated Statements of Operations.

We reassessed the recognition and measurement of identifiable assets and liabilities acquired and concluded that all acquired assets and liabilities were recognized and that the valuation procedures and resulting estimates of fair values were appropriate. The primary factor contributing to the gain relates to the change in the overall price of our common stock from the time that the Merger Agreement was executed on July 31, 2016 to the acquisition date. During this time, our stock price decreased from $230.01 to $185.04, which in turn reduced the fair value of the consideration.

b. What was the reason Tesla was able to acquire SolarCity for a bargain?

C. Tesla's year-end is December 31. The number reported above for the purchase allocation were preliminary as of the end of 2016. During 2017, Tesla made a measurement period adjustment that reduced the net assets acquired by $57.746 million. The measurement period adjustment reduced other assets by $11.571 million and increased accrued liabilities by $46,175 million. The finalized bargain gain is $30.981 million.

a. What is the journal entry to record the measurement period adjustment?

b. How is the bargain gain reported in 2016 and 2017?

D. Statement of cash flows:

a. Where is the stock issued for the SolarCity acquisition reported on the statement of cash flows?

b. How much cash was acquired in the acquisition? Where is this cash reported in the statement of cash flows?

AFS2-2 **EBay Acquires Skype LO 7**

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

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

Conditions of the earnout: The maximum amount potentially payable under the performance-based earnout is approximately 1.1 billion euro, or approximately $1.5 billion (based on a U.S. dollar–to–euro exchange rate of $1.32), and would be payable in cash or common stock. The earn–out payments are contingent upon Skype achieving certain net revenue, gross profit margin–based, and active user targets. Base earnout payments of up to an aggregate of approximately 877 million euro, or approximately $1.2 billion, weighted equally among the three

targets, would be payable if the targets are achieved over any four-quarter period commencing on January 1, 2006 through June 30, 2009. Additional bonus earnout payments of up to an aggregate of approximately 292 million euro, or approximately $386 million, weighted equally among the three targets, would be payable if Skype exceeds the targets during calendar year 2008. Any contingent earnout payments made would be accounted for as additional purchase price and would increase goodwill. As of December 31, 2006, the targets had not been met and accordingly, no payments had been made.

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

Required:

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

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

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

AFS2-3

eBay Sells Skype LO 5

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

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

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

From eBay's 2009 annual report:

Required:

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

eBay Inc.
Consolidated Statement of Income

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

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

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

AFS2-4

Measurement Period Adjustments and Contingent Consideration LO 6

Consider the following footnote from a company's 2012 10K concerning an acquisition occurring during February of 2011 (The Company's year end is January 31). The measurement period adjustment did not occur until January 2012.

Based on our initial internal estimate of contingent shares to be issued as part of this agreement, we had estimated that the total fair value of the common stock shares issued and contingently issuable for this transaction on the acquisition date was $367,500 (1,750,000 shares).

The Company originally recognized a liability based on the acquisition date fair value of the acquisition-related contingent consideration based on the probability of the achievement of the targets stipulated in the Purchase Agreement. Based on the Company's estimation, an initial liability of $367,500 was recorded. Subsequently, we have reassessed our estimates and have determined that the initial terms of the agreement have not be met, and as the result, we have determined that there will be no additional shares contingently issuable under the terms of the Purchase Agreement and we have recorded an adjustment to revise our initial estimate of the purchase price in contemplation that no contingent consideration as was previously reported in our interim financial statements.

The following table summarizes the preliminary and final determination of the purchase price and fair value of AHI's assets acquired at the date of acquisiton:

	Preliminary	*Final*
Purchase price calculation:		
Common stock issued (1,000,000 shares)	210,000	210,000
Contingent consideration (1,750,000 shares of common stock)	367,500	–
Fair value of total consideration	577,500	210,000
Allocation of purchase price:		
Intellectual property and technical know-how	577,500	–
Goodwill	–	210,000
Fair value of total consideration	577,500	210,000

As of January, 31, 2012, based upon the completion of the Company's annual goodwill imnpairment test, it was determined that the goodwill associated with the AHI acquisition has been impaired, and as the result, the Company has recorded an impairment loss of $210,000. The cause of the impairment was the result of contracts that were anticipated to result from this acquisition that have not materialized and management has decided to focus its energies on new initiatives.

Required:

A. When did the company record the measurement period adjustment? In your opinion, is this an appropriate use of a measurement period adjustment? Why or why not?

B. Assuming the company had not made a measurement period adjustment, prepare the journal entries that would have been needed to adjust the contingent consideration to zero and record the impairment of the intangibles. How does this differ from what the company actually reported?

C. What incentives might management have for presenting their financial statements as they did rather than using the method that you recorded in part B above? Support your answer with numbers and words.

AFS2-5 **Bargain Purchase LO 7**

Consider the following information from Alliance Data Systems Corporation 2009 10K.

On October 30, 2009, the Company assumed the operations of the Charming Shoppes' credit card program, including the service center operations associated with Charming Shoppes' branded card progams, portfolio and securitization master trust. The transaction consisted of purchasing existing accounts and the rights to new accounts along with certain other assets that are required to support the securitization program including retained certificates and interests, cash collateral accounts, and an interest-only strip, totaling a combined $158.9 million. The Company obtained control of the assets and assumed the liabilities on October 30, 2009, the acquisition date. The reults of operations for this acquisition have been included since the date of acquisition and are reflected in the Private Label Services and Private Label Credit segments.

The Company engaged a third-party specialist to assist it in the measurement of the fair value of the assets required. The fair value of the assets acquired exceeded the cost of the acquisition. Consequently, the Company reassessed the recognition and measurement of the identifiable assets acquired and liabilities assumed and concluded that the valuation procedures and resulting measures were appropriate. The excess value of the net assets acquired over the purchase price has been recorded as a bargain purchase gain, which is included in gain on acquisition of a business in the Company's consolidated statements of income. The following table summarizes the fair values of the assets acquired and liabilities assumed in the Charming Shoppes' acquisition as of the date of purchase.

	As of October 30, 2009 (in thousands)
Current assets	$ 24,910
Property, plant and equipment	491
Due from securitization	108,554
Identifiable intangible assets	67,200
Total assets acquired	201,155
Current Liabilities	8,500
Deferred tax liability	12,527
Total liabilities assumed	21,027
Net assets acquired	$ 180,128
Total consideration paid	158,901
Gain on business combination	$ 21,227

Required:

1. FASB ASC paragraph 805-30-50-1(f) requires a description of the reasons why the transaction resulted in a gain. In addition, the acquirer is required to reassess the valuations if a bargain purchase is indicated. Did Alliance Data Systems do either (or both) of these? Be specific.
2. Speculate as to some of the reasons that a bargain purchase might occur. Why has FASB struggled to find the appropriate accounting for bargains (changing the rules repeatedly)?
3. Assuming the acquisition is an asset acquisition treated as a business combination, prepare the journal entry on the acquirer's books to record the acquisition.

EXERCISES

EXERCISE 2-1 Asset Purchase LO 6

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

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

Required:

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

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

EXERCISE 2-2 **Acquisition Method LO 6**

The balance sheets of Petrello Company and Sanchez Company as of January 1, 2019, are presented below. On that date, after an extended period of negotiation, the two companies agreed to merge. To effect the merger, Petrello Company is to exchange its unissued common stock for all the outstanding shares of Sanchez Company in the ratio of ½ share of Petrello for each share of Sanchez. Market values of the shares were agreed on as Petrello, $48; Sanchez, $24. The fair values of Sanchez Company's assets and liabilities are equal to their book values with the exception of plant and equipment, which has an estimated fair value of $720,000.

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

Required:

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

EXERCISE 2-3 **Asset Purchase, Cash and Stock LO 6**

Pretzel Company acquired the assets (except for cash) and assumed the liabilities of Salt Company on January 2, 2020. As compensation, Pretzel Company gave 30,000 shares of its common stock, 15,000 shares of its 10% preferred stock, and cash of $50,000 to the stockholders of Salt Company. On the acquisition date, Pretzel Company stock had the following characteristics:

PRETZEL COMPANY

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

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

SALT COMPANY
Balance Sheet
January 2, 2020

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

Required:

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

Exercise 2-4

Asset Purchase, Cash LO 6

P Company acquired the assets and assumed the liabilities of S Company on January 1, 2018, for $510,000 when S Company's balance sheet was as follows:

S COMPANY
Balance Sheet
January 1, 2018

Cash	$ 96,000
Receivables	55,200
Inventory	110,400
Land	169,200
Plant and equipment (net)	466,800
Total	$897,600
Accounts payable	$ 44,400
Bonds payable, 10%, due 12/31/2023, Par	480,000
Common stock, $2 par value	120,000
Retained earnings	253,200
Total	$897,600

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

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

Required:

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

Exercise 2-5

Asset Purchase, Contingent Consideration as a Liability LO 7

Pritano Company acquired all the net assets of Succo Company on December 31, 2018, for $2,160,000 cash. The balance sheet of Succo Company immediately prior to the acquisition showed:

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

As part of the negotiations, Pritano agreed to pay the stockholders of Succo $360,000 cash if the post-combination earnings of Pritano averaged $2,160,000 or more per year over the next two years. The estimated fair value of the contingent consideration was $144,000 on the date of the acquisition.

Required:

A. Prepare the journal entries on the books of Pritano to record the acquisition on December 31, 2018.

B. At the end of 2019, the estimated fair value of the contingent consideration increased to $200,000. Prepare the journal entry to record the change in the fair value of the contingent consideration, if needed.

C. In 2020, the earnings did not meet the earnout target and the estimated fair value of the contingent consideration was zero. Prepare the journal entry to record the change in the fair value of the contingent consideration.

Exercise 2-6 **Asset Purchase, Contingent Consideration as Equity LO 7**

Assume the same information as in Exercise 2-5 except that instead of paying a cash earnout, Pritano Company agreed to issue 10,000 additional shares of its $10 par value common stock to the stockholders of Succo if the average postcombination earnings over the next three years equaled or exceeded $2,500,000. The fair value of the contingent consideration on the date of acquisition was estimated to be $200,000. The contingent consideration (earnout) was classified as equity rather than as a liability.

Required:

A. Prepare the journal entries on the books of Pritano to record the acquisition on December 31, 2018.

B. On January 1, 2022, the additional 10,000 shares of Pritano's stock were issued because the earnout targets were met. On this date, Pritano's stock price was $50 per share. Prepare the journal entry to record the issuance of the shares of stock.

Exercise 2-7 **Multiple Choice LO 6**

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

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

Required:

Select the letter of the best answer.

1. If the business combination is treated as a purchase and Sims Company's net assets have a fair value of $228,800, Price Company's balance sheet immediately after the combination will include goodwill of
   (a) $10,200.
   (b) $12,800.
   (c) $11,200.
   (d) $18,800.
2. If the business combination is treated as a purchase and the fair value of Sims Company's current assets is $90,000, its plant and equipment is $242,000, and its liabilities are $56,000, Price Company's balance sheet immediately after the combination will include
   (a) Negative goodwill of $36,000.
   (b) Plant and equipment of $817,000.
   (c) Gain of $36,000.
   (d) Goodwill of $36,000.

Exercise 2-8 **Purchase LO 6**

Effective December 31, 2018, Zintel Corporation proposes to issue additional shares of its common stock in exchange for all the assets and liabilities of Smith Corporation and Platz Corporation, after which Smith and Platz will distribute the Zintel stock to their stockholders in complete liquidation and dissolution. Balance sheets of each of the corporations immediately prior to merger on December 31, 2018, follow. The common stock exchange ratio was negotiated to be 1:1 for both Smith and Platz.

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

Required:

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

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

Exercise 2-9 **Allocation of Purchase Price to Various Assets and Liabilities LO 6**

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

Case A

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

S COMPANY

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

Case B

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

S COMPANY

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

Case C

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

S COMPANY

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

Required:

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

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

Exercise 2-10

Goodwill Impairment Test LO 3

On January 1, 2018, Porsche Company acquired the net assets of Saab Company for $450,000 cash. The fair value of Saab's identifiable net assets was $375,000 on this date. Porsche Company decided to measure goodwill impairment using the present value of future cash flows to estimate the fair value of the reporting unit (Saab). The information for these subsequent years is as follows:

Year	*Present Value of Future Cash Flows*	*Carrying Value of Saab's Identifiable Net Assets**	*Fair Value Saab's Identifiable Net Assets*
2019	$400,000	$330,000	$340,000
2020	$400,000	$320,000	345,000
2021	$350,000	$300,000	325,000

*Identifiable net assets do not include goodwill.

Required:

Part A: For each year determine the amount of goodwill impairment, if any using FASB's simplified approach (assume that either the qualitative test is satisfied or bypassed).

Part B: Prepare the journal entries needed each year to record the goodwill impairment (if any) on Porsche's books from 2019 to 2021.

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

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

Part E: Optional. If the firm has not yet adopted the new simplified rules on goodwill impairment and uses the two-step approach. Determine the amount of goodwill impairment (Illustration 2-1 is available from your instructor.)

Exercise 2-11 **Relation between Purchase Price, Goodwill, and Negative Goodwill LO 6**

The following balance sheets were reported on January 1, 2019, for Peach Company and Stream Company:

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

Required:

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

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

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

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

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

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

PROBLEMS

PROBLEM 2-1 Consolidation LO 6

Condensed balance sheets for Phillips Company and Solina Company on January 1, 2018, are as follows:

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

On January 1, 2018, the stockholders of Phillips and Solina agreed to a consolidation. Because FASB requires that one party be recognized as the acquirer and the other as the acquiree, it was agreed that Phillips was acquiring Solina. Phillips agreed to issue 20,000 shares of its $10 par stock to acquire all the net assets of Solina at a time when the fair value of Phillips' common stock was $15 per share.

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

Required:

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

PROBLEM 2-2 Merger and Consolidation, Goodwill Impairment LO 3 LO 6

Stockholders of Acme Company, Baltic Company, and Colt Company are considering alternative arrangements for a business combination. Balance sheets and the fair values of each company's assets on October 1, 2019, were as follows:

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

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

Required:

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

by issuing in exchange 140,000 shares of its common stock to Baltic Company and 40,000 shares of its common stock to Colt Company.

B. Assume, further, that the acquisition was consummated on October 1, 2019, as described above. However, by the end of 2020, Acme was concerned that the fair values of one or both of the acquired units had deteriorated. To test for impairment, Acme decided to measure goodwill impairment using the present value of future cash flows to estimate the fair value of the reporting units (Baltic and Colt). Acme accumulated the following data:

Year 2015	*Present Value of Future Cash Flows*	*Carrying Value of Identifiable Net Assets**	*Fair Value Identifiable Net Assets*
Baltic	$6,500,000	$6,340,000	$6,350,000
Colt	$1,900,000	1,200,000	1,000,000

*Identifiable Net Assets do not include goodwill.

Prepare the journal entry, if needed, to record goodwill impairment at December 31, 2020. Use FASB's simplified approach to test for goodwill impairment (assume that the qualitative test is satisfied or bypassed).

PROBLEM 2-3 **Purchase of Net Assets Using Bonds LO 6**

On January 1, 2019, Perez Company acquired all the assets and assumed all the liabilities of Stalton Company and merged Stalton into Perez. In exchange for the net assets of Stalton, Perez gave its bonds payable with a maturity value of $600,000, a stated interest rate of 10%, interest payable semiannually on June 30 and December 31, a maturity date of January 1, 2029, and a yield rate of 12%. Balance sheets for Perez and Stalton (as well as fair value data) on January 1, 2019, were as follows:

	Perez	*Stalton*	
	Book Value	*Book Value*	*Fair Value*
Cash	$ 250,000	$114,000	$114,000
Receivables	352,700	150,000	135,000
Inventories	848,300	232,000	310,000
Land	700,000	100,000	315,000
Buildings	950,000	410,000	54,900
Accumulated depreciation—buildings	(325,000)	(170,500)	
Equipment	262,750	136,450	39,450
Accumulated depreciation—equipment	(70,050)	(90,450)	
Total assets	$2,968,700	$881,500	$968,350
Current liabilities	$ 292,700	$ 95,300	$ 95,300
Bonds payable, 8% due 1/1/2024, Interest payable 6/30 and 12/31		300,000	260,000
Common stock, $15 par value	1,200,000		
Common stock, $5 par value		236,500	
Other contributed capital	950,000	170,000	
Retained earnings	526,000	79,700	
Total equities	$2,968,700	$881,500	

Required:

Prepare the journal entry on the books of Perez Company to record the acquisition of Stalton Company's assets and liabilities in exchange for the bonds.