CHAPTER 2
CONSOLIDATION OF FINANCIAL INFORMATION

Accounting standards for business combination are found in FASB ASC Topic 805, “Business Combinations” and Topic 810, “Consolidation.” These standards require the acquisition method which emphasizes acquisition-date fair values for recording all combinations.

In this chapter, we first provide coverage of expansion through corporate takeovers and an overview of the consolidation process. Then we present the acquisition method of accounting for business combinations followed by limited coverage of the purchase method and pooling of interests provided in the Appendix 2A and pushdown accounting in Appendix 2B.

Chapter Outline

I. Business combinations and the consolidation process
  A. A business combination is the formation of a single economic entity, an event that occurs whenever one company gains control over another
  B. Business combinations can be created in several different ways
    1. Statutory merger—only one of the original companies remains in business as a legally incorporated enterprise.
      a. Assets and liabilities can be acquired with the seller then dissolving itself as a corporation.
      b. All of the capital stock of a company can be acquired with the assets and liabilities then transferred to the buyer followed by the seller’s dissolution.
    2. Statutory consolidation—assets or capital stock of two or more companies are transferred to a newly formed corporation
    3. Acquisition by one company of a controlling interest in the voting stock of a second. Dissolution does not take place; both parties retain their separate legal incorporation.
  C. Financial information from the members of a business combination must be consolidated into a single set of financial statements representing the entire economic entity.
    1. If the acquired company is legally dissolved, a permanent consolidation is produced on the date of acquisition by entering all account balances into the financial records of the surviving company.
    2. If separate incorporation is maintained, consolidation is periodically simulated whenever financial statements are to be prepared. This process is carried out through the use of worksheets and consolidation entries. Consolidation worksheet entries are used to adjust and eliminate subsidiary company accounts. Entry “S” eliminates the equity accounts of the subsidiary. Entry “A” allocates exess payment amounts to identifiable assets and liabilities based on the fair value of the subsidiary accounts. (Consolidation journal entries are never recorded in the books of either company, they are worksheet entries only.)

II. The Acquisition Method
  A. The acquisition method replaced the purchase method. For combinations resulting in complete ownership, it is distinguished by four characteristics.
    1. All assets acquired and liabilities assumed in the combination are recognized and measured at their individual fair values (with few exceptions).
    2. The fair value of the consideration transferred provides a starting point for valuing and recording a business combination.
      a. The consideration transferred includes cash, securities, and contingent performance obligations.
      b. Direct combination costs are expensed as incurred.
      c. Stock issuance costs are recorded as a reduction in paid-in capital.
      d. The fair value of any noncontrolling interest also adds to the valuation of the acquired firm and is covered beginning in Chapter 4 of the text.
    3. Any excess of the fair value of the consideration transferred over the net amount assigned to the individual assets acquired and liabilities assumed is recognized by the acquirer as goodwill.
    4. Any excess of the net amount assigned to the individual assets acquired and liabilities assumed over the fair value of the consideration transferred is recognized by the acquirer as a “gain on bargain purchase.”
  B. In-process research and development acquired in a business combination is recognized as an asset at its acquisition-date fair value.

III. Convergence between U.S. GAAP and IAS IFRS 3 – nearly identical to U.S. GAAP because of joint efforts

APPENDIX 2A:

I. The Purchase Method
  A. The purchase method was applicable for business combinations occurring for fiscal years beginning prior to December 15, 2008. It was distinguished by three characteristics.
    1. One company was clearly in a dominant role as the purchasing party
    2. A bargained exchange transaction took place to obtain control over the second company.
    3. A historical cost figure was determined based on the acquisition price paid.
      a. The cost of the acquisition included any direct combination costs.
      b. Stock issuance costs were recorded as a reduction in paid-in capital and are not considered to be a component of the acquisition price.
  B. Purchase method procedures
    1. The assets and liabilities acquired were measured by the buyer at fair value as of the date of acquisition.
    2. Any portion of the payment made in excess of the fair value of these assets and liabilities was attributed to an intangible asset commonly referred to as goodwill.
    3. If the price paid was below the fair value of the assets and liabilities, the acquired company accounts were still measured at fair value except that certain noncurrent asset values were reduced by the excess cost. If these values were not great enough to absorb the entire reduction, an extraordinary gain was recognized.

II. The Pooling of Interest Method (prohibited for combinations after June 2002)

  A. A pooling of interests reflected united ownership of two companies through the exchange of equity securities. The characteristics of a pooling are fundamentally different from either the purchase or acquisition methods.
    1. Neither party was truly viewed as an acquiring company.
    2. Precise cost figures from the exchange of securities were difficult to ascertain.
    3. The transaction affected the stockholders rather than the companies.

  B. Pooling of interests accounting
    1. Because of the nature of a pooling, an acquisition price was not relevant.
      a. Since no acquisition price was computed, all direct costs of creating the combination were expensed immediately.
      b. No new goodwill was recognized from the combination. Similarly, no valuation adjustments were recorded for any of the subsidiary assets or liabilities.
    2. The book values of the two companies were simply brought together to produce consolidated financial statements. A pooling was viewed as a uniting of the owners rather than the two companies.
    3. The results of operations reported by both parties were combined on a retroactive basis as if the companies had always been together.
    4. Controversy historically surrounded the pooling of interests method.
      a. Cost figures indicated by the exchange transaction were ignored.
      b. Income balances previously reported were combined on a retrospective basis.
      c. Reported net income was usually higher in subsequent years than in a purchase because the lack of valuation adjustments reduced amortization.

APPENDIX 2B: Pushdown Accounting

I. Pushdown accounting is the application of the parent’s acquisition-date valuations for the subsidiary’s standalone financial statements. A newly acquired entity may elect the option to apply pushdown accounting in the reporting period immediately following the acquisition. The rationale is that the acquisition-date fair values for the subsidiary’s assets and liabilities are more representationally faithful and relevant to users of the subsidiary’s financial statements.

II. When push-down accounting is elected,

  A. The subsidiary revalues its assets and liabilities based on the acquisition-date fair value allocations. The subsidiary then recognizes periodic amortization expense on those allocations with definite lives. Therefore, the subsidiary’s recorded income equals its impact on consolidated earnings (except in the presence of a bargain purchase gain).

  B. Any goodwill from the combination is reported in the acquired entity’s separate financial statements. In the case of a bargain purchase gain, pushdown accounting recognize an adjustment to its additional paid-in capital, not as a gain in its income statement.

  C. the subsidiary’s retained earnings are revalued to zero recognizing the new reporting entity as of the parent’s acquisition date.

III. The parent uses no special procedures when push-down accounting is being applied. However, if the equity method is in use, amortization need not be recognized by the parent since that expense is included in the figure reported by the subsidiary.

Answers to Questions

1. A business combination is the process of forming a single economic entity by the uniting of two or more organizations under common ownership. The term also refers to the entity that results from this process.

2. (1) A statutory merger is created whenever two or more companies come together to form a business combination and only one remains in existence as an identifiable entity. This arrangement is often instituted by the acquisition of substantially all of an enterprise's assets. (2) A statutory merger can also be produced by the acquisition of a company's capital stock. This transaction is labeled a statutory merger if the acquired company transfers its assets and liabilities to the buyer and then legally dissolves as a corporation. (3) A statutory consolidation results when two or more companies transfer all of their assets or capital stock to a newly formed corporation. The original companies are being "consolidated" into the new entity. (4) A business combination is also formed whenever one company gains control over another through the acquisition of outstanding voting stock. Both companies retain their separate legal identities although the common ownership indicates that only a single economic entity exists.

3. Consolidated financial statements represent accounting information gathered from two or more separate companies. This data, although accumulated individually by the organizations, is brought together (or consolidated) to describe the single economic entity created by the business combination.

4. Companies that form a business combination will often retain their separate legal identities as well as their individual accounting systems. In such cases, internal financial data continues to be accumulated by each organization. Separate financial reports may be required for outside shareholders (a noncontrolling interest), the government, debt holders, etc. This information may also be utilized in corporate evaluations and other decision making. However, the business combination must periodically produce consolidated financial statements encompassing all of the companies within the single economic entity. The purpose of a worksheet is to organize and structure this process. The worksheet allows for a simulated consolidation to be carried out on a regular, periodic basis without affecting the financial records of the various component companies.

5. Several situations can occur in which the fair value of the 50,000 shares being issued might be difficult to ascertain. These examples include:
   - The shares may be newly issued (if Jones has just been created) so that no accurate value has yet been established;
   - Jones may be a closely held corporation so that no fair value is available for its shares;
   - The number of newly issued shares (especially if the amount is large in comparison to the quantity of previously outstanding shares) may cause the price of the stock to fluctuate widely so that no accurate fair value can be determined during a reasonable period of time;
   - Jones' stock may have historically experienced drastic swings in price. Thus, a quoted figure at any specific point in time may not be an adequate or representative value for long-term accounting purposes.

6. For combinations resulting in complete ownership, the acquisition method allocates the fair value of the consideration transferred to the separately recognized assets acquired and liabilities assumed based on their individual fair values.

7. The revenues and expenses (both current and past) of the **parent** are included within reported figures. However, the revenues and expenses of the subsidiary are

consolidated from the date of the acquisition forward within the worksheet consolidation process. The operations of the subsidiary are only applicable to the business combination if earned subsequent to its creation.

8. Morgan's additional acquisition value may be attributed to many factors: expected synergies between Morgan's and Jennings' assets, favorable earnings projections, competitive bidding to acquire Jennings, etc. In general however, any amount paid by the parent company in excess of the fair values of the subsidiary's net assets acquired is reported as goodwill.
9. In the vast majority of cases the assets acquired and liabilities assumed in a business combination are recorded at their fair values. If the fair value of the consideration transferred (including any contingent consideration) is less than the total net fair value assigned to the assets acquired and liabilities assumed, then an ordinary gain on bargain purchase is recognized for the difference.
10. Shares issued are recorded at fair value as if the stock had been sold and the money obtained used to acquire the subsidiary. The Common Stock account is recorded at the par value of these shares with any excess amount attributed to additional paid-in capital.
11. The direct combination costs of $98,000 are allocated to expense in the period in which they occur. Stock issue costs of $56,000 are treated as a reduction of APIC.

Answers to Problems

1. D
2. B
3. D
4. A
5. B
6. A
7. A
8. B
9. C
10. C

11. B	Consideration transferred (fair value)		$800,000
	Cash	$150,000	
	Accounts receivable	140,000	
	Software	320,000	
	Research and development asset	200,000	
	Liabilities	(130,000)	
	Fair value of net *identifiable* assets acquired		680,000
	Goodwill		$120,000

12. C	Legal and accounting fees accounts payable	$15,000
	Contingent liabilility	20,000
	Donovan’s liabilities assumed	60,000
	Liabilities assumed or incurred	$95,000

13. D	Consideration transferred (fair value)		$420,000
	Current assets	$90,000	
	Building and equipment	250,000	
	Unpatented technology	25,000	
	Research and development asset	45,000	
	Liabilities	(60,000)	
	Fair value of net *identifiable* assets acquired		350,000
	Goodwill		$ 70,000

Current assets	$ 90,000
Building and equipment	250,000
Unpatented technology	25,000
Research and development asset	45,000
Goodwill	70,000
Total assets	$480,000

14. C	**Value of shares issued (51,000 × $3)**	**$153,000**
	Par value of shares issued (51,000 × $1)	**51,000**
	Additional paid-in capital (new shares)	**$102,000**
	Additional paid-in capital (existing shares)	**90,000**
	Consolidated additional paid-in capital (fair value)	**$192,000**

At the acquisition date, the parent makes no change to retained earnings.

15. B	**Consideration transferred (fair value)**	**$400,000**
	Book value of subsidiary (assets minus liabilities)	**(300,000)**
	Fair value in excess of book value	**100,000**
	Allocation of excess fair over book value identified with specific accounts:	
	Inventory	**30,000**
	Patented technology	**20,000**
	Land	**25,000**
	Long-term liabilities	**10,000**
	Goodwill	**$15,000**

16. D	**TruData patented technology**	**$230,000**
	Webstat patented technology (fair value)	**200,000**
	Acquisition-date consolidated balance sheet amount	**$430,000**

17. C	**TruData common stock before acquisition**	**$300,000**
	Common stock issued (par value)	**50,000**
	Acquisition-date consolidated balance sheet amount	**$350,000**

18. B	**TruData's 1/1 retained earnings**	**$130,000**
	TruData's income (1/1 to 7/1)	**80,000**
	Acquisition-date consolidated balance sheet amount	**$210,000**

19. C	**Patrick's assets**	**$1,395,000**
	Less: investment in Sean	**(460,000)**
	Sean's assets	**415,000**
	Inventory write-up	**25,000**
	Goodwill from the combination (see below)	**145,000**
	Total consolidated assets	**$1,520,000**

Consideration transferred	**$460,000**
Fair value of net identifiable assets	**315,000**
Goodwill	**$145,000**

20. B Patrick's stockholders' equity total.

21. a. An intangible asset acquired in a business combination is recognized as an asset apart from goodwill if it arises from contractual or other legal rights (regardless of whether those rights are transferable or separable from the acquired enterprise or from other rights and obligations). If an intangible asset does not arise from contractual or other legal rights, it shall be recognized as an asset apart from goodwill only if it is separable, that is, it is capable of being separated or divided from the acquired enterprise and sold, transferred, licensed, rented, or exchanged (regardless of whether there is an intent to do so). An intangible asset that cannot be sold, transferred, licensed, rented, or exchanged individually is considered separable if it can be sold, transferred, licensed, rented, or exchanged with a related contract, asset, or liability.

b.
- ■ **Trademarks—usually meet both the separability and legal/contractual criteria.**
- ■ **Customer list—usually meets the separability criterion.**
- ■ **Copyrights on artistic materials—usually meet both the separability and legal/contractual criteria.**
- ■ **Agreements to receive royalties on leased intellectual property—usually meet the legal/contractual criterion.**
- ■ **Unpatented technology—may meet the separability criterion if capable of being sold even if in conjunction with a related contract, asset, or liability.**

22. (12 minutes) (Journal entries to record a merger—acquired company dissolved)

Inventory	**600,000**	
Land	**990,000**	
Buildings	**2,000,000**	
Customer Relationships	**800,000**	
Goodwill	**690,000**	
Accounts Payable		**80,000**
Common Stock		**40,000**
Additional Paid-In Capital		**960,000**
Cash		**4,000,000**
Professional Services Expense	**42,000**	
Cash		**42,000**
Additional Paid-In Capital	**25,000**	
Cash		**25,000**

23. (12 minutes) (Journal entries to record a bargain purchase—acquired company dissolved)

Inventory	**600,000**	
Land	**990,000**	
Buildings	**2,000,000**	
Customer Relationships	**800,000**	
Accounts Payable		**80,000**
Cash		**4,200,000**
Gain on Bargain Purchase		**110,000**
Professional Services Expense	**42,000**	
Cash		**42,000**

24. (15 Minutes) (Consolidated balances)

In acquisitions, the fair values of the subsidiary's assets and liabilities are consolidated (there are a limited number of exceptions). Goodwill is reported at $80,000, the amount that the $760,000 consideration transferred exceeds the $680,000 fair value of Sol’s net assets acquired.

- **Inventory = $670,000 (Padre's book value plus Sol's fair value)**
- **Land = $710,000 (Padre's book value plus Sol's fair value)**
- **Buildings and equipment = $930,000 (Padre's book value plus Sol's fair value)**
- **Franchise agreements = $440,000 (Padre's book value plus Sol's fair value)**
- **Goodwill = $80,000 (calculated above)**
- **Revenues = $960,000 (only parent company operational figures are reported at date of acquisition)**
- **Additional paid-in capital = $265,000 (Padre's book value adjusted for stock issue less stock issuance costs)**
- **Expenses = $940,000 (only parent company operational figures plus acquisition-related costs are reported at date of acquisition)**
- **Retained earnings, 1/1 = $390,000 (Padre's book value only)**
- **Retained earnings, 12/31 = $410,000 (beginning retained earnings plus revenues minus expenses, of Padre only)**

25. (20 minutes) Journal entries for a merger using alternative values.

a. Acquisition date fair values:

Cash paid	**$700,000**
Contingent performance liability	**35,000**
Consideration transferred	**$735,000**
Fair values of net assets acquired	**750,000**
Gain on bargain purchase	**$ 15,000**

Receivables	**90,000**	
Inventory	**75,000**	
Copyrights	**480,000**	
Patented Technology	**700,000**	
Research and Development Asset	**200,000**	
Current liabilities		**160,000**
Long-Term Liabilities		**635,000**
Cash		**700,000**
Contingent Performance Liability		**35,000**
Gain on Bargain Purchase		**15,000**

Professional Services Expense	**100,000**	
Cash		**100,000**

b. Acquisition date fair values:

Cash paid	**$800,000**
Contingent performance liability	**35,000**
Consieration transferred	**$835,000**
Fair values of net assets acquired	**750,000**
Goodwill	**$ 85,000**

Receivables	**90,000**	
Inventory	**75,000**	
Copyrights	**480,000**	
Patented Technology	**700,000**	
Research and Development Asset	**200,000**	
Goodwill	**85,000**	
Current Liabilities		**160,000**
Long-Term Liabilities		**635,000**
Cash		**800,000**
Contingent Performance Liability		**35,000**

Professional Services Expense	**100,000**	
Cash		**100,000**

26. (20 Minutes) (Determine selected consolidated balances)

Under the acquisition method, the shares issued by Wisconsin are recorded at fair value using the following journal entry:

Investment in Badger (value of debt and shares issued)	**900,000**	
Common Stock (par value)		**150,000**
Additional Paid-In Capital (excess over par value)		**450,000**
Liabilities		**300,000**

The payment to the broker is accounted for as an expense. The stock issue cost is a reduction in additional paid-in capital.

Professional Services Expense	**30,000**	
Additional Paid-In Capital	**40,000**	
Cash		**70,000**

Allocation of Acquisition-Date Excess Fair Value:

Consideration transferred (fair value) for Badger Stock	**$900,000**
Book Value of Badger, 6/30	**770,000**
Fair Value in Excess of Book Value	**$130,000**
Excess fair value (undervalued equipment)	**100,000**
Excess fair value (overvalued patented technology)	**(20,000)**
Goodwill	**$ 50,000**

CONSOLIDATED BALANCES:

a.	**Net income (adjusted for professional services expense. The figures earned by the subsidiary prior to the takeover are not included)**	**$ 210,000**
b.	**Retained earnings, 1/1 (the figures earned by the subsidiary prior to the takeover are not included)**	**800,000**
c.	**Patented technology (the parent's book value plus the fair value of the subsidiary)**	**1,180,000**
d.	**Goodwill (computed above)**	**50,000**
e.	**Liabilities (the parent's book value plus the fair value of the subsidiary's debt plus the debt issued by the parent in acquiring the subsidiary)**	**1,210,000**
f.	**Common stock (the parent's book value after recording the newly-issued shares)**	**510,000**
g.	**Additional Paid-in Capital (the parent's book value after recording the two entries above)**	**680,000**

27. (20 minutes) (Preparation of a consolidated balance sheet)*

CASEY CORPORATION AND CONSOLIDATED SUBSIDIARY KENNEDY
Worksheet for a Consolidated Balance Sheet
January 1, 2018

	Casey	Kennedy	Adjust. & Elim.		Consolidated
Cash	457,000	172,500			629,500
Accounts receivable	1,655,000	347,000			2,002,000
Inventory	1,310,000	263,500			1,573,500
Investment in Kennedy	3,300,000	-0-		(S) 2,600,000 (A) 700,000	-0-
Buildings (net)	6,315,000	2,090,000	(A) 382,000		8,787,000
Licensing agreements	-0-	3,070,000		(A) 108,000	2,962,000
Goodwill	347,000	-0-	(A) 426,000		773,000
Total assets	13,384,000	5,943,000			16,727,000
Accounts payable	(394,000)	(393,000)			(787,000)
Long-term debt	(3,990,000)	(2,950,000)			(6,940,000)
Common stock	(3,000,000)	(1,000,000)	(S) 1,000,000		(3,000,000)
Additional paid-in cap.	-0-	(500,000)	(S) 500,000		-0-
Retained earnings	(6,000,000)	(1,100,000)	(S) 1,100,000		(6,000,000)
Total liab. & equities	(13,384,000)	(5,943,000)	3,408,000	3,408,000	(16,727,000)

***Although this solution uses a worksheet to compute the consolidated amounts, the problem does not require it.**

28. (50 Minutes) (Determine consolidated balances for a bargain purchase.)

a. Marshall's acquisition of Tucker represents a bargain purchase because the fair value of the net assets acquired exceeds the fair value of the consideration transferred as follows:

Fair value of net assets acquired	$515,000
Fair value of consideration transferred	400,000
Gain on bargain purchase	$115,000

In a bargain purchase, the acquisition is recorded at the fair value of the net assets acquired instead of the fair value of the consideration transferred (an exception to the general rule).

Prior to preparing a consolidation worksheet, Marshall records the three transactions that occurred to create the business combination.

Investment in Tucker	515,000	
Long-term Liabilities		200,000
Common Stock (par value)		20,000
Additional Paid-In Capital		180,000
Gain on Bargain Purchase		115,000

(To record liabilities and stock issued for Tucker acquisition fair value)

28. ***(continued)***

Professional Services Expense.........................	**30,000**	
Cash		**30,000**
(to record payment of professional fees)		

Additional Paid-In Capital	**12,000**	
Cash		**12,000**
(To record payment of stock issuance costs)		

Marshall's trial balance is adjusted for these transactions (as shown in the worksheet that follows).

Next, the $400,000 fair value of the investment is allocated:

Consideration transferred at fair value.................................		**$400,000**
Book value (assets minus liabilities or total stockholders' equity)..		**460,000**
Book value in excess of consideration transferred		**(60,000)**
Allocation to specific accounts based on fair value:		
Inventory...	**5,000**	
Land	**20,000**	
Buildings...	**30,000**	**55,000**
Gain on bargain purchase (excess net asset fair value over consideration transferred)..		**$(115,000)**

CONSOLIDATED TOTALS

- **Cash = $38,000. Add the two book values less acquisition and stock issue costs**
- **Receivables = $360,000. Add the two book values.**
- **Inventory = $505,000. Add the two book values plus the fair value adjustment**
- **Land = $400,000. Add the two book values plus the fair value adjustment.**
- **Buildings = $670,000. Add the two book values plus the fair value adjustment.**
- **Equipment = $210,000. Add the two book values.**
- **Total assets = $2,183,000. Summation of the above individual figures.**
- **Accounts payable = $190,000. Add the two book values.**
- **Long-term liabilities = $830,000. Add the two book values plus the debt incurred by the parent in acquiring the subsidiary.**
- **Common stock = $130,000.The parent's book value after stock issue to acquire the subsidiary.**
- **Additional paid-in capital = $528,000.The parent's book value after the stock issue to acquire the subsidiary less the stock issue costs.**
- **Retained earnings = $505,000. Parent company balance less $30,000 in professional services expense plus $115,000 gain on bargain purchase.**
- **Total liabilities and equity = $2,183,000. Summation of the above figures.**

28. ***(continued)***

b.

MARSHALL COMPANY AND CONSOLIDATED SUBSIDIARY
Worksheet
January 1, 2018

	Marshall	*Tucker*	*Consolidation Entries*		*Consolidated*
Accounts	*Company**	*Company*	*Debit*	*Credit*	*Totals*
Cash...	18,000	20,000			38,000
Receivables	270,000	90,000			360,000
Inventory	360,000	140,000	(A) 5,000		505,000
Land	200,000	180,000	(A) 20,000		400,000
Buildings (net)	420,000	220,000	(A) 30,000		670,000
Equipment (net)	160,000	50,000			210,000
Investment in Tucker	515,000			(S) 460,000	
				(A) 55,000	-0-
Total assets	1,943,000	700,000			2,183,000
Accounts payable......................	(150,000)	(40,000)			(190,000)
Long-term liabilities	(630,000)	(200,000)			(830,000)
Common stock	(130,000)	(120,000)	(S) 120,000		(130,000)
Additional paid-in capital	(528,000)	-0-			(528,000)
Retained earnings, 1/1/18	(505,000)	(340,000)	(S) 340,000		(505,000)
Total liab. and owners' equity ..	(1,943,000)	(700,000)	515,000	515,000	(2,183,000)

Marshall's accounts have been adjusted for acquisition entries (see part a.).

29. (Prepare a consolidated balance sheet)

Consideration transferred at fair value		$495,000
Book value		265,000
Excess fair over book value		230,000
Allocation of excess fair value to specific assets and liabilities:		
to computer software	$50,000	
to equipment	(10,000)	
to client contracts	100,000	
to in-process research and development	40,000	
to notes payable	(5,000)	175,000
Goodwill		$ 55,000

	Pratt	Spider	Debit	Credit	Consolidated
Cash	36,000	18,000			54,000
Receivables	116,000	52,000			168,000
Inventory	140,000	90,000			230,000
Investment in Spider	495,000	-0-		(S) 265,000 (A) 230,000	-0-
Computer software	210,000	20,000	(A) 50,000		280,000
Buildings (net)	595,000	130,000			725,000
Equipment (net)	308,000	40,000		(A) 10,000	338,000
Client contracts	-0-	-0-	(A) 100,000		100,000
Research and devlopment asset	-0-	-0-	(A) 40,000		40,000
Goodwill	-0-	-0-	(A) 55,000		55,000
Total assets	1,900,000	350,000			1,990,000
Accounts payable	(88,000)	(25,000)			(113,000)
Notes payable	(510,000)	(60,000)		(A) 5,000	(575,000)
Common stock	(380,000)	(100,000)	(S)100,000		(380,000)
Additional paid-in capital	(170,000)	(25,000)	(S) 25,000		(170,000)
Retained earnings	(752,000)	(140,000)	(S)140,000		(752,000)
Total liabilities and equities	(1,900,000)	(350,000)	510,000	510,000	(1,990,000)

29. *(continued)*

Pratt Company and Subsidiary
Consolidated Balance Sheet
December 31, 2018

Assets		***Liabilities and Owners' Equity***	
Cash	$ 54,000	Accounts payable	$ 113,000
Receivables	168,000	Notes payable	575,000
Inventory	230,000		
Computer software	280,000		
Buildings (net)	725,000		
Equipment (net)	338,000		
Client contracts	100,000		
Research and development asset	40,000	Common stock	380,000
		Additional paid in capital	170,000
Goodwill	55,000	Retained earnings	752,000
Total assets	$1,990,000	Total liabilities and equities	$1,990,000

30. (15 minutes) (Acquisition method entries for a merger)

Case 1:

Fair value of consideration transferred	$145,000
Fair value of net identifiable assets	120,000
Excess to goodwill	$25,000

Case 1 journal entry on Allerton's books:

Current Assets	60,000	
Building	50,000	
Land	20,000	
Trademark	30,000	
Goodwill	25,000	
Liabilities		40,000
Cash		145,000

Case 2: Bargain Purchase under acquisition method

Fair value of consideration transferred	$110,000
Fair value of net identifiable assets	120,000
Gain on bargain purchase	$ 10,000

Case 2 journal entry on Allerton's books:

Current Assets	60,000	
Building	50,000	
Land	20,000	
Trademark	30,000	
Gain on Bargain Purchase		10,000
Liabilities		40,000
Cash		110,000

Problem 30. (continued)

In a bargain purchase, the acquisition method employs the fair value of the net identifiable assets acquired as the basis for recording the acquisition. Because this basis exceeds the amount paid, Allerton recognizes a gain on bargain purchase. This is an exception to the general rule of using the fair value of the consideration transferred as the basis for recording the combination.

31. (25 minutes) (Combination entries—acquired entity dissolved)

Cash consideration transferred	**$310,800**
Contingent performance obligation	**17,900**
Consideration transferred (fair value)	**328,700**
Fair value of net identifiable assets	**294,700**
Goodwill	**$ 34,000**

Journal entries:

Receivables	**83,900**	
Inventory	**70,250**	
Buildings	**122,000**	
Equipment	**24,100**	
Customer List	**25,200**	
Research and Development Asset	**36,400**	
Goodwill	**34,000**	
Current Liabilities		**12,900**
Long-Term Liabilities		**54,250**
Contingent Performance Liability		**17,900**
Cash		**310,800**
Professional Services Expense	**15,100**	
Cash		**15,100**

32. (30 Minutes) (Overview of the steps in applying the acquisition method when shares have been issued to create a combination. Part *h*. includes a bargain purchase.)

a. The fair value of the consideration includes

Fair value of stock issued	**$1,500,000**
Contingent performance obligation	**30,000**
Fair value of consideration transferred	**$1,530,000**

b. Stock issue costs reduce additional paid-in capital.

c. In a business combination, direct acquisition costs (such as fees paid to investment banks for arranging the transaction) are recognized as expenses.

d. The par value of the 20,000 shares issued is recorded as an increase of $20,000 in the Common Stock account. The $74 fair value in excess of par value ($75 – $1) is an increase to additional paid-in capital of $1,480,000 ($74 × 20,000 shares).

e.

Fair value of consideration transferred (above)		**$1,530,000**
Receivables	**$ 80,000**	
Patented technology	**700,000**	
Customer relationships	**500,000**	
In-process research and development	**300,000**	
Liabilities	**(400,000)**	**1,180,000**
Goodwill		**$ 350,000**

f. Revenues and expenses of the subsidiary from the period prior to the combination are omitted from the consolidated totals. Only the operational figures for the subsidiary after the purchase are applicable to the business combination. The previous owners earned any previous profits.

g. The subsidiary's Common Stock and Additional Paid-in Capital accounts have no impact on the consolidated totals.

h. The fair value of the consideration transferred is now $1,030,000. This amount indicates a bargain purchase calculated as follows:

Fair value of consideration transferred		**$1,030,000**
Receivables	**$ 80,000**	
Patented technology	**700,000**	
Customer relationships	**500,000**	
Research and development asset	**300,000**	
Liabilities	**(400,000)**	**1,180,000**
Gain on bargain purchase		**$ 150,000**

The values of SafeData's assets and liabilities would be recorded at fair value, but there would be no goodwill recognized and a gain on bargain purchase would be reported.

33. (50 Minutes) (Prepare balance sheet for a statutory merger using the acquisition method. Also, use worksheet to derive consolidated totals.)

a. In accounting for the combination of NewTune and On-the-Go, the fair value of the acquisition is allocated to each identifiable asset and liability acquired with any remaining excess attributed to goodwill.

Fair value of consideration transferred (shares issued)		**$750,000**
Fair value of net assets acquired:		
Cash	**$ 29,000**	
Receivables	**63,000**	
Trademarks	**225,000**	
Record music catalog	**180,000**	
In-process research and development	**200,000**	
Equipment	**105,000**	
Accounts payable	**(34,000)**	
Notes payable	**(45,000)**	**723,000**
Goodwill		**$ 27,000**

Journal entries by NewTune to record combination with On-the-Go:

Cash	**29,000**	
Receivables	**63,000**	
Trademarks	**225,000**	
Record Music Catalog	**180,000**	
Research and Development Asset	**200,000**	
Equipment	**105,000**	
Goodwill	**27,000**	
Accounts Payable		**34,000**
Notes Payable		**45,000**
Common Stock (NewTune par value)		**60,000**
Additional Paid-In Capital		**690,000**
(To record merger with On-the-Go at fair value)		
Additional Paid-In Capital	**25,000**	
Cash		**25,000**
(Stock issue costs incurred)		

Problem 33 (continued):

Post-Combination Balance Sheet:

Assets		**Liabilities and Owners' Equity**	
Cash	**$ 64,000**	**Accounts payable**	**$ 144,000**
Receivables	**213,000**	**Notes payable**	**415,000**
Trademarks	**625,000**		
Record music catalog	**1,020,000**		
Research and development asset	**200,000**	**Common stock**	**460,000**
Equipment	**425,000**	**Additional paid-in capital**	**695,000**
Goodwill	**27,000**	**Retained earnings**	**860,000**
Total	**$2,574,000**	**Total**	**$2,574,000**

b. Because On-the-Go continues as a separate legal entity, NewTune first records the acquisition as an investment in the shares of On-the-Go.

Journal entries:

Investment in On-the-Go	**750,000**	
Common Stock (NewTune, Inc., par value)		**60,000**
Additional Paid-In Capital		**690,000**
(To record acquisition of On-the-Go's shares)		
Additional Paid-In Capital	**25,000**	
Cash		**25,000**
(Stock issue costs incurred)		

Next, NewTune's accounts are adjusted for the two immediately preceding entries to facilitate the worksheet preparation of the consolidated financial statements.

33. (continued)

b.

NEWTUNE, INC., AND ON-THE-GO CO.
Consolidation Worksheet
January 1, 2018

			Consolidation Entries		*Consolidated*
Accounts	***NewTune, Inc.***	***On-the-Go Co.***	***Debit***	***Credit***	***Totals***
Cash	**35,000**	**29,000**			**64,000**
Receivables	**150,000**	**65,000**		**(A) 2,000**	**213,000**
Investment in On-the-Go	**750,000**	**-0-**		**(S) 270,000**	
				(A) 480,000	**-0-**
Trademarks	**400,000**	**95,000**	**(A) 130,000**		**625,000**
Record music catalog	**840,000**	**60,000**	**(A) 120,000**		**1,020,000**
Research and development asset	**-0-**	**-0-**	**(A) 200,000**		**200,000**
Equipment	**320,000**	**105,000**			**425,000**
Goodwill	**-0-**	**-0-**	**(A) 27,000**		**27,000**
Totals	**2,495,000**	**354,000**			**2,574,000**
Accounts payable	**110,000**	**34,000**			**144,000**
Notes payable	**370,000**	**50,000**	**(A) 5,000**		**415,000**
Common stock	**460,000**	**50,000**	**(S) 50,000**		**460,000**
Additional paid-in capital	**695,000**	**30,000**	**(S) 30,000**		**695,000**
Retained earnings	**860,000**	**190,000**	**(S) 190,000**		**860,000**
Totals	**2,495,000**	**354,000**	**752,000**	**752,000**	**2,574,000**

Note: **The accounts of NewTune have already been adjusted for the first three journal entries indicated in the answer to Part b. to record the acquisition fair value and the stock issuance costs.**

The consolidation entries are designed to:

- **Eliminate the stockholders' equity accounts of the subsidiary (S)**
- **Record all subsidiary assets and liabilities at fair value (A)**
- **Recognize the goodwill indicated by the acquisition fair value (A)**
- **Eliminate the Investment in On-the-Go account (S, A)**

c. The consolidated balance sheets in parts a. and b. above are identical. The financial reporting consequences for a 100% stock acquisition vs. a merger are the same. The economic substances of the two forms of the transaction are identical and, therefore, so are the resulting financial statements. The difference is in the journal entry to record the acquisition in the parent company books.

34. (40 minutes) (Prepare a consolidated balance sheet using the acquisition method).

a. Journal entries to record the acquisition on Pacifica's records.

Investment in Seguros	**1,062,500**	
Common Stock (50,000 × $5)		**250,000**
Additional Paid-In Capital (50,000 × $15)		**750,000**
Contingent Performance Obligation		**62,500**

The contingent consideration is computed as:
$130,000 payment × 50% probability × 0.961538 present value factor

Professional Services Expense	**15,000**	
Cash		**15,000**
Additional Paid-In Capital	**9,000**	
Cash		**9,000**

b. and c.

	Pacifica	Seguros	Consolidation Entries		Consolidated Balance Sheet
Revenues	(1,200,000)				(1,200,000)
Expenses	890,000				890,000
Net income	(310,000)				(310,000)
Retained earnings, 1/1	(950,000)				(950,000)
Net income	(310,000)				(310,000)
Dividends declared	90,000				90,000
Retained earnings, 12/31	(1,170,000)				(1,170,000)
Cash	86,000	85,000			171,000
Receivables and inventory	750,000	190,000		(A) 10,000	930,000
Property, plant and equipment	1,400,000	450,000	(A)150,000		2,000,000
Investment in Seguros	1,062,500			(S) 705,000 (A) 357,500	0
Research and development asset			(A)100,000		100,000
Goodwill			(A) 77,500		77,500
Trademarks	300,000	160,000	(A) 40,000		500,000
Total assets	3,598,500	885,000			3,778,500
Liabilities	(500,000)	(180,000)			(680,000)
Contingent performance obligation	(62,500)				(62,500)
Common stock	(650,000)	(200,000)	(S) 200,000		(650,000)
Additional paid-in capital	(1,216,000)	(70,000)	(S) 70,000		(1,216,000)
Retained earnings	(1,170,000)	(435,000)	(S) 435,000		(1,170,000)
Total liabilities and equities	(3,598,500)	(885,000)	1,072,500	1,072,500	(3,778,500)

Answers to Appendix 2A Problems

35. (25 minutes) Journal entries for a merger using legacy purchase method. Also compare to acquisition method.

a. Purchase Method

1. **Purchase price (including acquisition costs)**	**$635,000**
Fair values of net assets acquired	**525,000**
Goodwill	**$110,000**

Journal entry:

Current Assets	**80,000**	
Equipment	**180,000**	
Trademark	**320,000**	
Goodwill	**110,000**	
Liabilities		**55,000**
Cash		**635,000**

2. Acquisition date fair values:

Purchase price (including acquisition costs)	**$450,000**
Fair values of net assets acquired	**525,000**
Bargain purchase	**($ 75,000)**

Allocation of bargain purchase to long-term assets acquired:

	Fair value	Prop.	Total reduction	Asset reduction
Equipment	**$180,000**	**36% x**	**$75,000 =**	**$27,000**
Trademark	**320,000**	**64% x**	**75,000 =**	**48,000**
	$500,000			**$75,000**

Journal entry:

Current Assets	**80,000**	
Equipment ($180,000 – $27,000)	**153,000**	
Trademark ($320,000 – $48,000)	**272,000**	
Liabilities		**55,000**
Cash		**450,000**

35. continued

b. Acquisition Method

1. **Consideration transferred**	**$ 610,000**
Fair values of net assets acquired	**525,000**
Goodwill	**$ 85,000**

Journal entry:

Current Assets	**80,000**	
Equipment	**180,000**	
Trademark	**320,000**	
Goodwill	**85,000**	
Liabilities		**55,000**
Cash		**610,000**
Professional Services Expense	**25,000**	
Cash		**25,000**

2. **Consideration transferred**	**$425,000**
Fair values of net assets acquired	**525,000**
Gain on bargain purchase	**($100,000)**

Journal entry:

Current Assets	**80,000**	
Equipment	**180,000**	
Trademark	**320,000**	
Liabilities		**55,000**
Gain on Bargain Purchase		**100,000**
Cash		**425,000**
Professional Services Expense	**25,000**	
Cash		**25,000**

36. (25 minutes) (Pooling vs. purchase involving an unrecorded intangible)

a.

	Purchase	Pooling
Inventory	$ 650,000	$ 600,000
Land	750,000	450,000
Buildings	1,000,000	900,000
Unpatented technology	1,500,000	-0-
Goodwill	600,000	-0-
Total	$4,500,000	$1,950,000

b. The purchase method excluded pre-acquisition revenues and expenses from consolidated results, but the pooling method included them.

c. Poolings typically produced higher rates of return on assets than purchase accounting because the denominator was often much lower. The Swimwear acquisition pooling produced an increment to total assets of $1,950,000 compared to $4,500,000 under purchase accounting. Future EPS under poolings were also higher because of lower future amortization of the smaller asset base. Managers whose compensation contracts involved accounting performance measures clearly had incentives to use pooling of interest accounting whenever possible.

Answers to Appendix 2B Problems

37. C

38. (12 minutes) (Pushdown Accounting Application)

Quigley Corporation
Balance Sheet
May 1

Cash	$ 95,000
Receivables	200,000
Inventory	260,000
Land	110,000
Building and equipment (net)	330,000
Patented technology	220,000
Goodwill	125,000
Total assets	$1,340,000
Accounts payable	$ 120,000
Long-term liabilities	510,000
Common stock—5 par value	210,000
Additional paid-in capital	90,000
APIC from pushown accounting	410,000
Retained earnings, 1/1	-0-
Total liabilities and stockholders' equity	$1,340,000

Chapter 2 Develop Your Skills

CONSIDERATION OR COMPENSATION CASE (estimated time 50 minutes)

According to FASB ASC (805-10-55-25):
If it is not clear whether an arrangement for payments to employees or selling shareholders is part of the exchange for the acquiree or is a transaction separate from the business combination, the acquirer should consider the following indicators:

a. **Continuing employment. The terms of continuing employment by the selling shareholders who become key employees may be an indicator of the substance of a contingent consideration arrangement. The relevant terms of continuing employment may be included in an employment agreement, acquisition agreement, or some other document. A contingent consideration arrangement in which the payments are automatically forfeited if employment terminates is compensation for postcombination services. Arrangements in which the contingent payments are not affected by employment termination may indicate that the contingent payments are additional consideration rather than compensation.**
b. **Duration of continuing employment. If the period of required employment coincides with or is longer than the contingent payment period, that fact may indicate that the contingent payments are, in substance, compensation.**
c. **Level of compensation. Situations in which employee compensation other than the contingent payments is at a reasonable level in comparison to that of other key employees in the combined entity may indicate that the contingent payments are additional consideration rather than compensation.**
d. **Incremental payments to employees. If selling shareholders who do not become employees receive lower contingent payments on a per-share basis than the selling shareholders who become employees of the combined entity, that fact may indicate that the incremental amount of contingent payments to the selling shareholders who become employees is compensation.**
e. **Number of shares owned. The relative number of shares owned by the selling shareholders who remain as key employees may be an indicator of the substance of the contingent consideration arrangement. For example, if the selling shareholders who owned substantially all of the shares in the acquiree continue as key employees, that fact may indicate that the arrangement is, in substance, a profit-sharing arrangement intended to provide compensation for postcombination services. Alternatively, if selling shareholders who continue as key employees owned only a small number of shares of the acquiree and all selling shareholders receive the same amount of contingent consideration on a per-share basis, that fact may indicate that the contingent payments are additional consideration. The preacquisition ownership interests held by parties related to selling shareholders who continue as key employees, such as family members, also should be considered.**
f. **Linkage to the valuation. If the initial consideration transferred at the acquisition date is based on the low end of a range established in the valuation of the acquiree and the contingent formula relates to that valuation approach, that fact may suggest that the contingent payments are additional consideration. Alternatively, if the contingent payment formula is consistent with prior profit-sharing arrangements, that fact may suggest that the substance of the arrangement is to provide compensation.**

g. Formula for determining consideration. The formula used to determine the contingent payment may be helpful in assessing the substance of the arrangement. For example, if a contingent payment is determined on the basis of a multiple of earnings, that might suggest that the obligation is contingent consideration in the business combination and that the formula is intended to establish or verify the fair value of the acquiree. In contrast, a contingent payment that is a specified percentage of earnings might suggest that the obligation to employees is a profit-sharing arrangement to compensate employees for services rendered.

Suggested answer:

Note: This case was designed to have conflicting indicators across the various criteria identified in the FASB ASC for determining the issue of compensation vs. consideration. Thus, the solution is subject to alternative explanations and student can be encouraged to use their own judgment and interpretations in supporting their answers.

In the author's judgment, the $8 million contingent payment (fair value = $4 million) is contingent consideration to be included in the overall fair value NaviNow records for its acquisition of TrafficEye. This contingency is not dependent on continuing employment (criteria a.), and uses a formula based on a component of earnings (criteria g.). Even though the four former owners of TrafficEye owned 100% of the shares (criteria e.), which suggests the $8 million is compensation, the overall fact pattern indicates consideration because no services are required for the payment.

The profit-sharing component of the employment contract appears to be compensation. Criteria g. specifically identifies profit-sharing arrangements as indicative of compensation for services rendered. Criteria a. also applies given that the employees would be unable to participate in profit-sharing if they terminate employment. Although the employees receive non-profit sharing compensation similar to other employees (criteria c.), the overall pattern of evidence suggests that any payments made under the profit-sharing arrangement should be recognized as compensation expense when incurred and not contingent consideration for the acquisition.

ASC RESEARCH CASE—DEFENSIVE INTANGIBLE ASSET (45 MINUTES)

a. The ASC Glossary defines a defensive intangible asset as
"An acquired intangible asset in a situation in which an entity does not intend to actively use the asset but intends to hold (lock up) the asset to prevent others from obtaining access to the asset."

ASC 820-10-35-10D also observes that
To protect its competitive position, or for other reasons, a reporting entity may intend not to use an acquired nonfinancial asset actively, or it may intend not to use the asset according to its highest and best use. For example, that might be the case for an acquired intangible asset that the reporting entity plans to use defensively by preventing others from using it. Nevertheless, the reporting entity shall measure the fair value of a nonfinancial asset assuming its highest and best use by market participants.

According to ASC 350-30-25-5 a defensive intangible asset should be accounted for as a separate unit of accounting (i.e., an asset separate from other assets of the acquirer). It should not be included as part of the cost of an entity's existing intangible asset(s) presumably because the defensive intangible asset is separately identifiable.

b. The identifiable assets acquired in a business combination should be measured at their acquisition-date fair values (ASC 805-20-30-1).

c. A fair value measurement assumes the highest and best use of an asset by market participants. Highest and best use is determined based on the use of the asset by market participants, even if the intended use of the asset by the reporting entity is different (ASC 820-10-35-10). Importantly, highest and best use provides maximum value to market participants. The highest and best use of the asset establishes the valuation premise used to measure the fair value of the asset—in this case an in-exchange premise maximizes the value of the asset at $2 million.

d. A defensive intangible asset shall be assigned a useful life that reflects the entity's consumption of the expected benefits related to that asset. The benefit a reporting entity receives from holding a defensive intangible asset is the direct and indirect cash flows resulting from the entity preventing others from realizing any value from the intangible asset (defensively or otherwise). An entity shall determine a defensive intangible asset's useful life, that is, the period over which an entity consumes the expected benefits of the asset, by estimating the period over which the defensive intangible asset will diminish in fair value. The period over which a defensive intangible asset diminishes in fair value is a proxy for the period over which the reporting entity expects a defensive intangible asset to contribute directly or indirectly to the future cash flows of the entity. (ASC 350-30-35A)

It would be rare for a defensive intangible asset to have an indefinite life because the fair value of the defensive intangible asset will generally diminish over time as a result of a lack of market exposure or as a result of competitive or other factors. Additionally, if an acquired intangible asset meets the definition of a defensive intangible asset, it shall not be considered immediately abandoned. (ASC 350-30-35B)

RESEARCH CASE—CELGENE'S ACQUISITION OF RECEPTOS

(40 Minutes)

1. **From Celgene's 2015 press release announcing the acquisition**

   > **The acquisition of Receptos significantly enhances Celgene's Inflammation & Immunology (I&I) portfolio, further diversifies the Company's revenue beginning in 2019 and beyond, and builds upon Celgene's growing expertise in inflammatory bowel disease (IBD). The transaction adds Ozanimod, a novel, potential best-in-class, oral, once-daily, selective sphingosine 1-phosphate 1 and 5 receptor modulator (S1P) to Celgene's deep and diverse pipeline of potential disease-altering medicines and investigational compounds.**

2. **Celgene accounted for its August 27, 2015 acquisition of Receptos using the acquisition method. Accordingly, Celgene recorded the acquisition at $7.62 billion.**

3. **According to ASC 805-30-30-11**

   > **The portion of the fair-value-based measure of the replacement award that is part of the consideration transferred in exchange for the acquiree equals the portion of the acquiree award that is attributable to pre-combination service.**

4. **From Celgene's 12/31/15 10-K report (dollars in millions)**

Cash consideration:

Cash		$7,311.2
Pre-combination service compensation		314.9
Total fair value of consideration transferred		7,626.2
Working capital (cash, A/R, A/P, etc.)	$ 479.2	
Property, plant, and equipment	5.0	
In-process research and development product rights	6,842.0	
Current deferred taxes	241.3	
Other non-current assets	7.9	
Non-current deferred tax liabilities	(2,519.2)	
Total fair value of net identifiable assets		5,056.2
Goodwill		$2,570.0

Celgene determined these allocations by estimating fair values for each of the assets acquired and the liabilities assumed.

5. **The fair value assigned to acquired IPR&D was based on the present value of expected after-tax cash flows attributable to ozanimod, which is in phase II and III testing. Ozanimod is an oral therapy for a variety of diseases including multiple sclerosis and others.**

6. **Acquired in-process research and development product rights are accounted for as an intangible asset with an indefinite life.**

RESEARCH CASE—ARCTIC CAT'S ACQUISITION OF MOTORFIST, LLC. (30 minutes)

1. According to Arctic Cat's 2015 10-K report

> **In February 2015, the Company acquired substantially all of the assets of MotorFist, LLC, a privately owned company based in Idaho Falls, Idaho, that designs, develops and distributes high-performance technical riding gear. The Company completed this acquisition to more broadly expand PG&A product offerings for our North America and international markets.**

2.

Total consideration transferred	**$9,118,000**
Fair value of "earnout"payments	**690,000**
Cash consideration	**$8,428,000**

3.

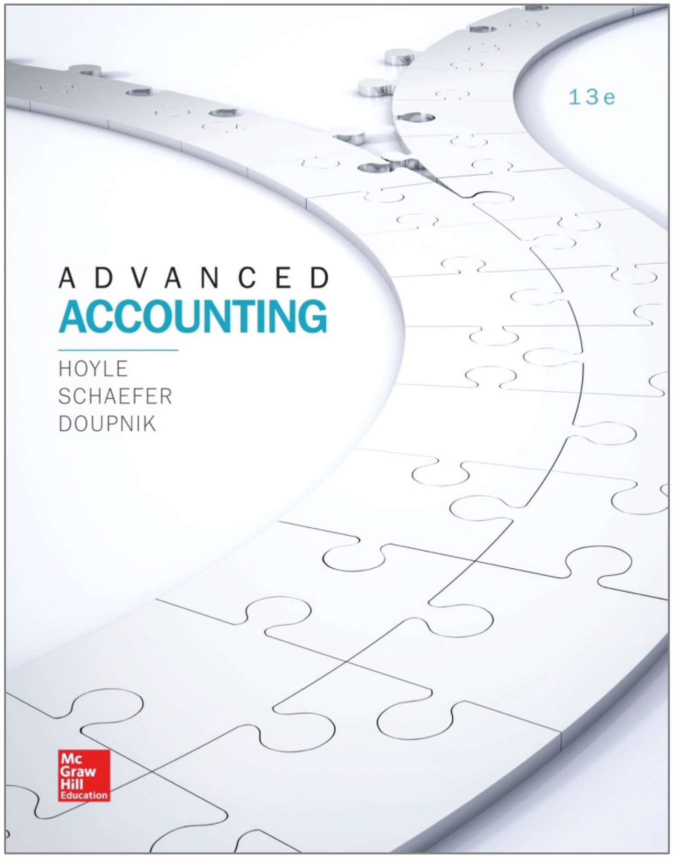
Consideration transferred		**$9,118,000**
Accounts receivable	**$1,137,000**	
Inventories	**1,579,000**	
Other	**636,000**	
Intangible assets	**2,580,000**	
Liabilities assumed	**(156,000)**	
Net identifiable assets acquired		**5,776,000**
Goodwill		**$3,342,000**

4. From Arctic Cat's 2015 10-K report, "The acquisition cost included contingent consideration consisting of up to five earnout payments, plus a catch-up payment, for a total of up to $4.0 million."

Because the contingent payments are described as "earnouts," it may be the case that the future payments depend upon the acquired company achieving certain levels of earnings, revenues, or some other performance metric.

Chapter Two

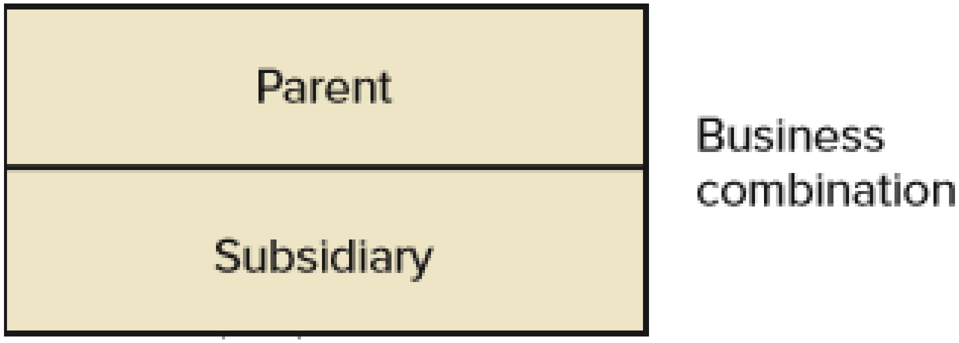
Consolidation of Financial Information



Current Accounting Standards for Business Combinations

The FASB Accounting Standards Codification (ASC) contains the current accounting standards for business combinations under the following topics:

- **"Business Combinations" (Topic 805)**
- **"Consolidation" (Topic 810)**



FASB ASC Topics 805 and 810

- **FASB Accounting Standards Codification (ASC) “Business Combinations” (Topic 805) and “Consolidation” (Topic 810) provide guidance using the *acquisition method*.**
- **The acquisition method embraces the *fair-value* measurement for measuring and assessing business activity.**

Learning Objective 2-1

Discuss the motives for business combinations.

Reasons for Firms to Combine

No two business combinations are exactly alike, but they share one or more of the following characteristics that potentially enhance profitability:

- Vertical integration.
- Cost savings.
- Quick entry for products into markets.
- Economies of scale.
- More attractive financing opportunities.
- Diversification of business risk.
- Business expansion.
- Increasingly competitive environment.

Recent Notable Business Combinations

EXHIBIT 2.1 Recent Notable Business Combinations

Acquirer	Target	Deal Value
AT&T	DirecTV	$47.4B
Berkshire Hathaway, Inc.	Precision Castparts	$32.0B
Visa, Inc.	Visa Europe Ltd	$23.3B
Facebook, Inc.	WhatsApp	$17.2B
MeadWestvaco	RockTenn	$16.0B
Intel Corporation	Altera Corporation	$15.0B
CVS Health Corporation	Omnicare, Inc.	$12.9B
Marriott	Starwood Hotels Intl	$12.2B
Merck	Cubist	$ 9.5B
Weyerhaeuser	Plum Creek Timber	$ 8.4B
Celgene Corporation	Receptos, Inc.	$ 7.2B
Cox Automotive	Dealertrack Technologies	$ 4.0B
FedEx	TNT Express	$ 4.8B
Expedia	HomeAway	$ 3.9B
Microsemi Corporation	PMC-Sierra, Inc.	$ 2.5B
Constellation Brands	Ballast Point Brewing & Spirits	$ 1.0B

Learning Objective 2-2

Recognize when consolidation of financial information into a single set of statements is necessary.

Consolidated Financial Reporting

Why consolidate financial information when two or more companies combine to create a single economic entity? According to FASB ASC (810-10-10-1):

- Consolidated financial statements provide more meaningful information than separate statements.
- Consolidated financial statements more fairly present the activities of the consolidated companies.
- Consolidated companies may retain their legal identities as separate corporations.

Consolidated Financial Reporting (continued)

To explain the process of preparing consolidated financial statements for a business combination, we address three questions:

1. **How is a business combination formed?**
2. **What constitutes a controlling financial interest?**
3. **How is the consolidation process carried out?**

Learning Objective 2-3

Define the term *business combination* and differentiate across various forms of business combinations.

Business Combinations

A business combination:

- Refers to a transaction or other event in which an acquirer obtains control over one or more businesses.
- Is formed by a wide variety of transactions or events with various formats.
- Can differ widely in legal form.
- Unites two or more enterprises into a single economic entity that requires consolidated financial statements.

Types of Business Combinations – Statutory Mergers

Statutory merger: Any business combination in which only one of the original companies continues to exist. The two types of statutory mergers are:

1. **A business combination in which one company obtains all of the assets, and often the liabilities, of another company.**
2. **A business combination in which one company obtains all of the capital stock of another company. The acquiring company must gain 100 percent control of all shares of stock before legally dissolving the company.**

Types of Business Combinations—Other Models

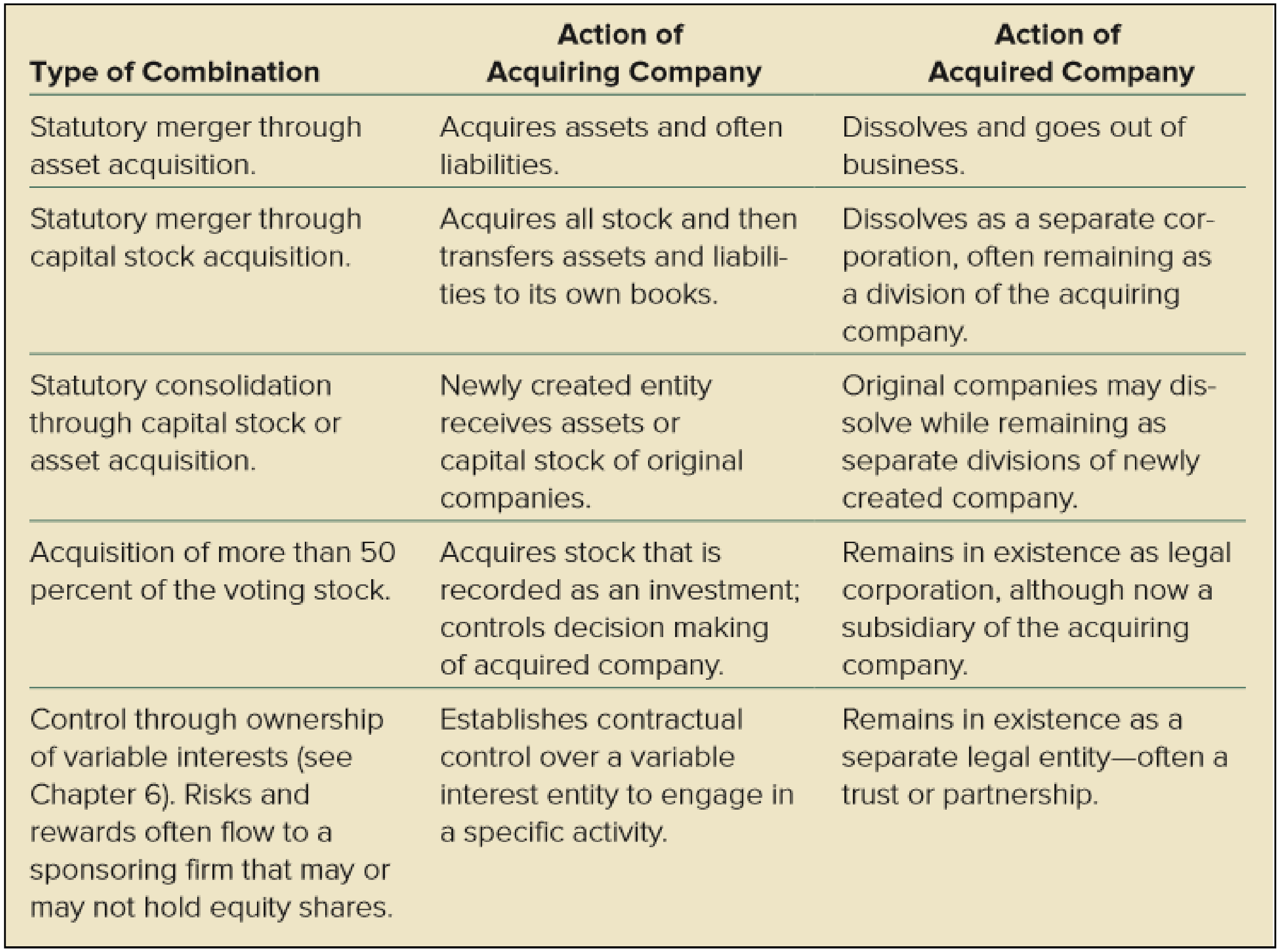
- Statutory consolidation: A specific type of business combination that unites two or more companies under the ownership of a newly created company. Two or more companies transfer either their assets or their capital stock to a newly formed corporation.
- Control without dissolution: When one company achieves legal control over another by acquiring a majority of voting stock, although control is present, no dissolution takes place. Each company remains in existence as an incorporated operation.

Types of Business Combinations— Variable Interest Entity (VIE)

- Variable interest entity (VIE): Vehicle for control exercised through contractual arrangements with a sponsoring firm that may not own the VIE but becomes its "primary beneficiary" with rights to its residual profits.
- Contract forms include leases, participation rights, guarantees, or other interests. Criticized in the past for providing sponsoring firms with off-balance-sheet financing and sometimes questionable profits.
- Current GAAP expands the notion of control and thus requires consolidation of VIEs by their primary beneficiary.

Formats of Business Combinations

EXHIBIT 2.2 Business Combinations



Type of Combination	Action of Acquiring Company	Action of Acquired Company
Statutory merger through asset acquisition.	Acquires assets and often liabilities.	Dissolves and goes out of business.
Statutory merger through capital stock acquisition.	Acquires all stock and then transfers assets and liabilities to its own books.	Dissolves as a separate corporation, often remaining as a division of the acquiring company.
Statutory consolidation through capital stock or asset acquisition.	Newly created entity receives assets or capital stock of original companies.	Original companies may dissolve while remaining as separate divisions of newly created company.
Acquisition of more than 50 percent of the voting stock.	Acquires stock that is recorded as an investment; controls decision making of acquired company.	Remains in existence as legal corporation, although now a subsidiary of the acquiring company.
Control through ownership of variable interests (see Chapter 6). Risks and rewards often flow to a sponsoring firm that may or may not hold equity shares.	Establishes contractual control over a variable interest entity to engage in a specific activity.	Remains in existence as a separate legal entity—often a trust or partnership.

FASB Control Model

The FASB ASC (810-10-15-8) provides guidance and describes *control* as follows:

> **The usual condition for a controlling financial interest is ownership of a majority voting interest, and, therefore, as a general rule ownership by one reporting entity, directly or indirectly, of more than 50 percent of the outstanding voting shares of another entity is a condition pointing toward consolidation.**

Consolidation of Financial Information

When one company gains control over another, a business combination is created, and a single set of consolidate financial statements must be prepared. How?

1. Parent's and subsidiary's financial data are brought together.
2. Financial position, results of operations, and cash flows are reported for the combined entity.
3. Reciprocal accounts and intra-entity transactions are adjusted or eliminated to ensure reported balances represent the single entity.

What Is to Be Consolidated and When?

- **If dissolution occurs:**
  All appropriate account balances are physically consolidated in the financial records of the survivor. Permanent consolidation occurs at the combination date.
- **If separate incorporation is maintained:**
  Only the financial statement information (on work papers, not the actual records) is consolidated. The consolidation process is carried out at regular intervals whenever financial statements are to be prepared.

How Does Consolidation Affect the Accounting Records?

- **If dissolution occurs:**
  Dissolved company's records are closed out. Surviving company's accounts are adjusted to include appropriate balances of the dissolved company.
- **If separate incorporation is maintained:**
  Each company continues to retain its own records. Worksheets facilitate the periodic consolidation process without disturbing individual accounting systems.

Learning Objective 2-4

Describe the valuation principles of the acquisition method.

The Acquisition Method

The acquisition method is required to account for a business combination. It embraces the fair value in measuring the acquirer's interest in the acquired business.

Applying the acquisition method involves using fair value to recognize and measure:

- The consideration transferred for the acquired business and any noncontrolling interest.
- Separately identified assets acquired and liabilities assumed.
- Goodwill, or a gain from a bargain purchase.

Fair Value

- GAAP requires that fair value of assets acquired and liabilities assumed in a business combination be determined at the acquisition date.
- Fair value: The price that would be received from selling an asset or paid for transferring a liability in an orderly transaction between market participants at the measurement date.

Valuation Techniques

ASC (820-10-35-28) identifies three valuation techniques:

1. The market approach estimates fair values using other market transactions involving similar assets or liabilities.
2. The income approach relies on multi-period estimates of future cash flows projected to be generated by an asset.
3. The cost approach estimates fair values by reference to the current cost of replacing an asset with another of comparable economic utility.

Goodwill and Gains on Bargain Purchases

What if the consideration transferred does NOT equal the fair value of the assets acquired?

- If the consideration transferred exceeds the net amount of the assets acquired and liabilities assumed, the difference is attributed to the asset goodwill by the acquiring company.
- If the fair value of the assets acquired and liabilities assumed exceeds the consideration transferred, a “gain on bargain purchase” is recognized by the acquiring business.

Learning Objective 2-5

Determine the total fair value of the consideration transferred for an acquisition and allocate that fair value to specific subsidiary assets acquired (including goodwill) and liabilities assumed or to a gain on bargain purchase.

Consideration Transferred = Fair Value of Net Assets Acquired Example

Assume that BigNet agrees to pay cash of $550,000 and to issue 20,000 previously unissued shares of its $10 par value common stock (currently selling for $100 per share) for all of Smallport's assets and liabilities.

Following the acquisition, Smallport then dissolves itself as a legal entity. The consideration transferred from BigNet to Smallport exactly equals the collective fair values of Smallport's assets less liabilities.

Procedures for Consolidating Financial Information

The $2,550,000 fair value of the consideration transferred by BigNet equals the collective fair values of Smallport's assets less liabilities and serves as the basis for recording the combination.

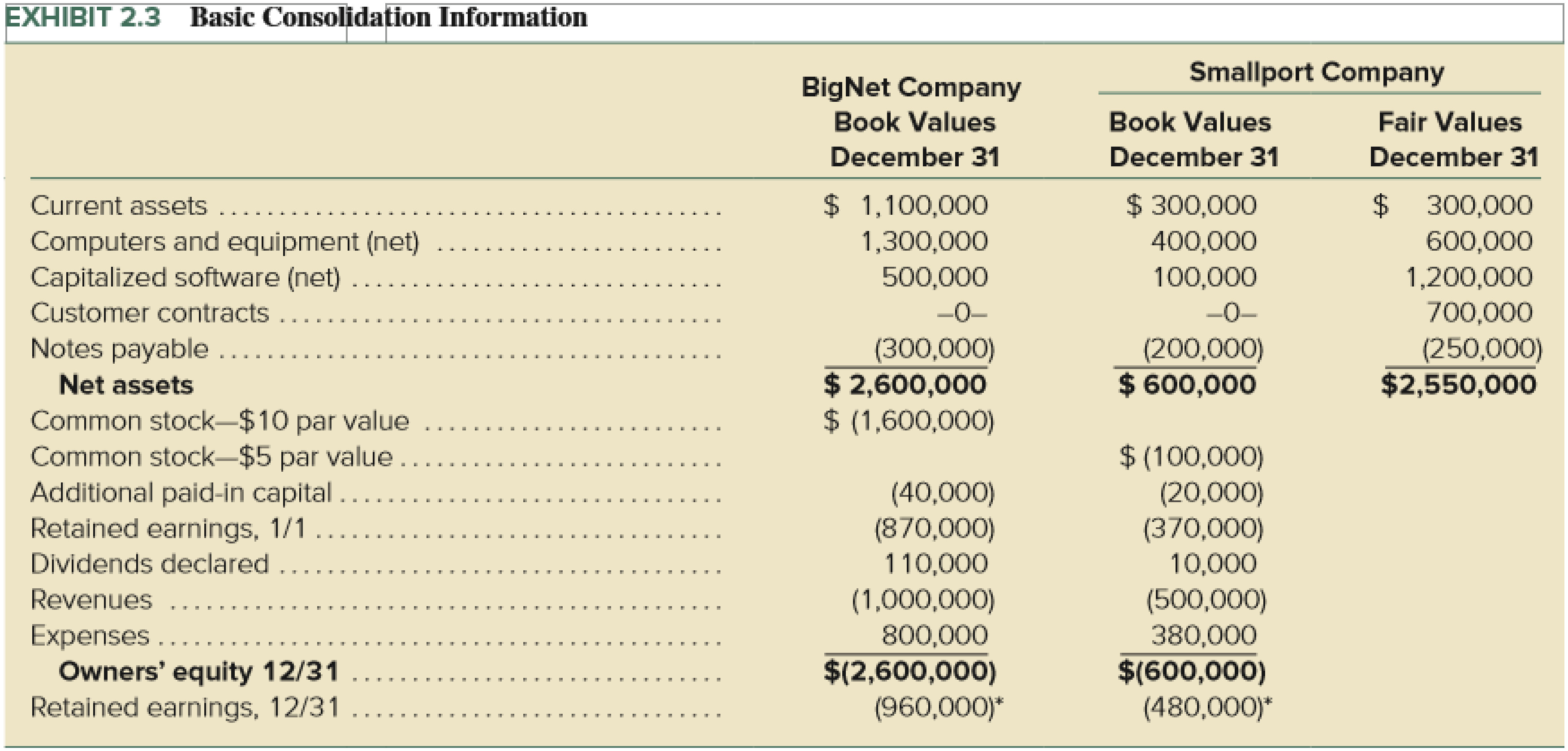


EXHIBIT 2.3 **Basic Consolidation Information**

	BigNet Company	Smallport Company	
	Book Values December 31	Book Values December 31	Fair Values December 31
Current assets	$ 1,100,000	$ 300,000	$ 300,000
Computers and equipment (net)	1,300,000	400,000	600,000
Capitalized software (net)	500,000	100,000	1,200,000
Customer contracts	–0–	–0–	700,000
Notes payable	(300,000)	(200,000)	(250,000)
Net assets	**$ 2,600,000**	**$ 600,000**	**$2,550,000**
Common stock—$10 par value	$ (1,600,000)		
Common stock—$5 par value		$ (100,000)	
Additional paid-in capital	(40,000)	(20,000)	
Retained earnings, 1/1	(870,000)	(370,000)	
Dividends declared	110,000	10,000	
Revenues	(1,000,000)	(500,000)	
Expenses	800,000	380,000	
Owners' equity 12/31	**$(2,600,000)**	**$(600,000)**	
Retained earnings, 12/31	(960,000)*	(480,000)*	

Procedures for Consolidating Financial Information (continued)

Legal and accounting distinctions divide business combinations into separate categories. Various procedures are utilized in this process according to the following sequence:

1. **Acquisition method when dissolution takes place.**
2. **Acquisition method when separate incorporation is maintained.**

When an acquired firm's legal status is dissolved in a business combination, the continuing firm owns the former firm's net assets.

Acquisition Method When Dissolution Takes Place

The continuing firm prepares a journal entry to record

- Fair value of the consideration transferred to acquire the dissolved firm.
- Identified assets acquired and liabilities assumed at their individual fair values.

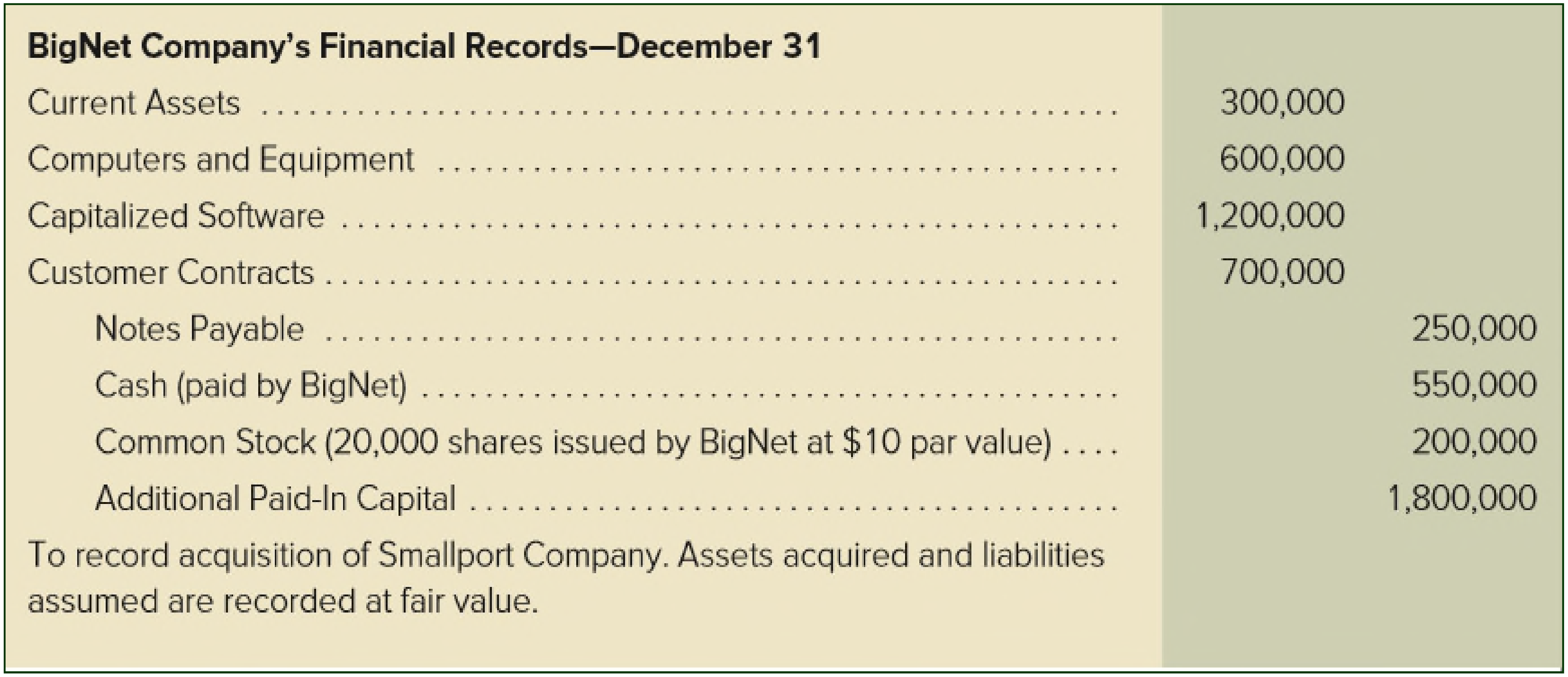
The entry to record the fair value of the combination depends on whether the consideration transferred is equal to, exceeds, or is less than the fair value of the net assets of the firm dissolved.

Learning Objective 2-6a

Prepare the journal entry to consolidate the accounts of a subsidiary if dissolution takes place.

Consideration Transferred = Fair Values of Net Assets Acquired—Subsidiary Dissolved

Under the acquisition method, BigNet records Smallport's assets and liabilities at fair value, ignoring original book values. Revenue, expense, dividend, and equity accounts cannot be transferred to a parent and are not included.



BigNet Company's Financial Records—December 31

Current Assets	300,000	
Computers and Equipment	600,000	
Capitalized Software	1,200,000	
Customer Contracts	700,000	
Notes Payable		250,000
Cash (paid by BigNet)		550,000
Common Stock (20,000 shares issued by BigNet at $10 par value)		200,000
Additional Paid-In Capital		1,800,000

To record acquisition of Smallport Company. Assets acquired and liabilities assumed are recorded at fair value.

Consideration Transferred Exceeds Fair Values of Net Assets Acquired and Liabilities Assumed

BigNet transfers to the owners of Smallport consideration of $1,000,000 in cash plus 20,000 shares of common stock with a fair value of $100 per share in exchange for ownership of the company. The $3,000,000 consideration transferred from BigNet to Smallport results in an excess amount exchanged over the fair value of the net assets acquired.

When the consideration transferred in an acquisition exceeds total net fair value of the identified assets and liabilities, the excess ($450,000 in this case) is allocated to an unidentifiable asset known as goodwill.

Journal Entry to Record an Acquisition Resulting in Goodwill

BigNet's $3,000,000 consideration results in $450,000 in excess of the fair value of Smallport's net assets. BigNet records $450,000 in goodwill and the fair value of each asset and liability in the following journal entry at the acquisition date.

BigNet Company's Financial Records—December 31

Current Assets	300,000	
Computers and Equipment	600,000	
Capitalized Software	1,200,000	
Customer Contracts	700,000	
Goodwill	450,000	
Notes Payable		250,000
Cash (paid by BigNet)		1,000,000
Common Stock (20,000 shares issued by BigNet at $10 par value)		200,000
Additional Paid-In Capital		1,800,000

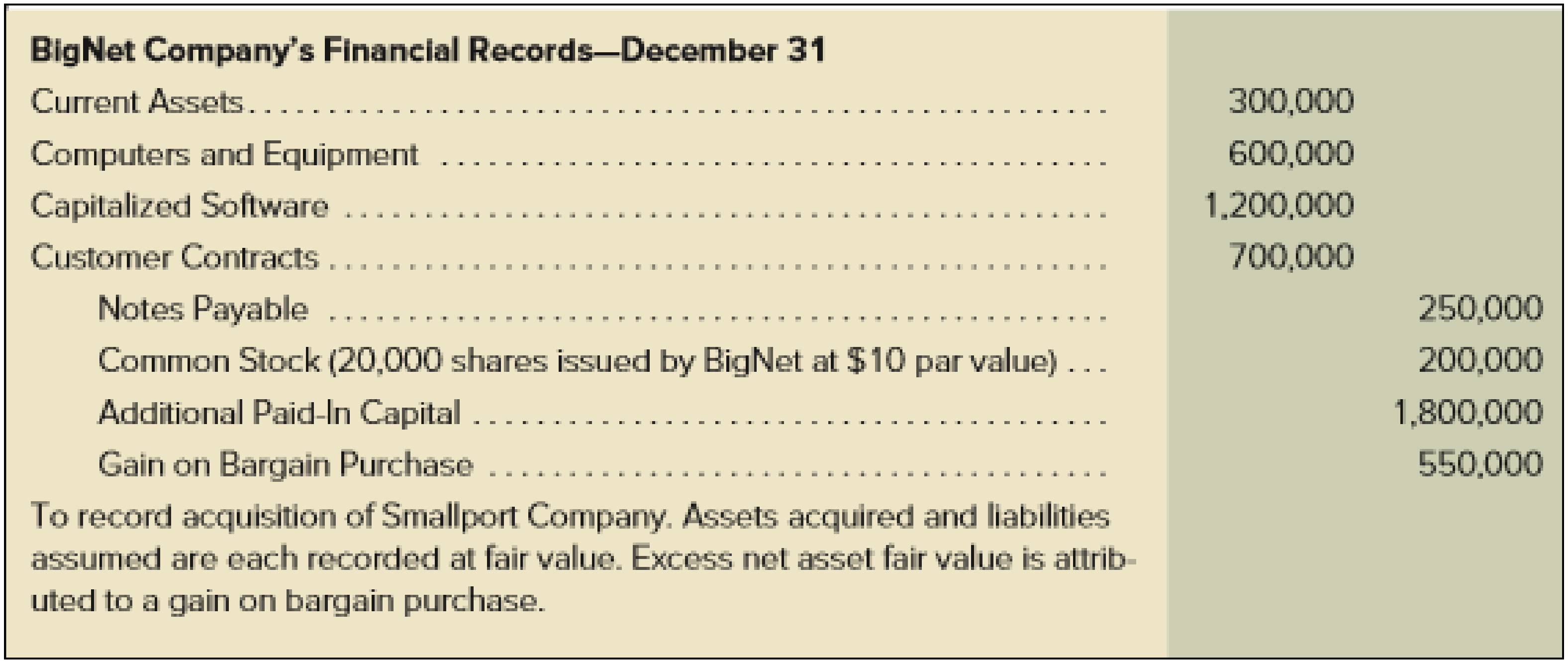
To record acquisition of Smallport Company. Assets acquired and liabilities assumed are recorded at individual fair values with excess fair value attributed to goodwill.

Consideration Transferred Is Less Than Net Identified Asset Fair Values

- **An exception to the general rule of recording business acquisitions at fair value of the consideration transferred occurs in the rare circumstance of a bargain purchase.**
- **Bargain purchase: The fair value of the consideration transferred by the acquirer is less than the fair value received in an acquisition, which is considered more relevant for asset valuation than the consideration transferred.**

Journal Entry to Record a Bargain Purchase

BigNet transfers consideration of $2,000,000 to the owners of Smallport in exchange for their business. BigNet conveys no cash and issues 20,000 shares of $10 par common stock that has a $100 per share fair value.



BigNet Company's Financial Records—December 31

Current Assets	300,000	
Computers and Equipment	600,000	
Capitalized Software	1,200,000	
Customer Contracts	700,000	
Notes Payable		250,000
Common Stock (20,000 shares issued by BigNet at $10 par value)		200,000
Additional Paid-In Capital		1,800,000
Gain on Bargain Purchase		550,000

To record acquisition of Smallport Company. Assets acquired and liabilities assumed are each recorded at fair value. Excess net asset fair value is attributed to a gain on bargain purchase.

Learning Objective 2-6b

Prepare the journal entry to record the various related costs involved in a business combination.

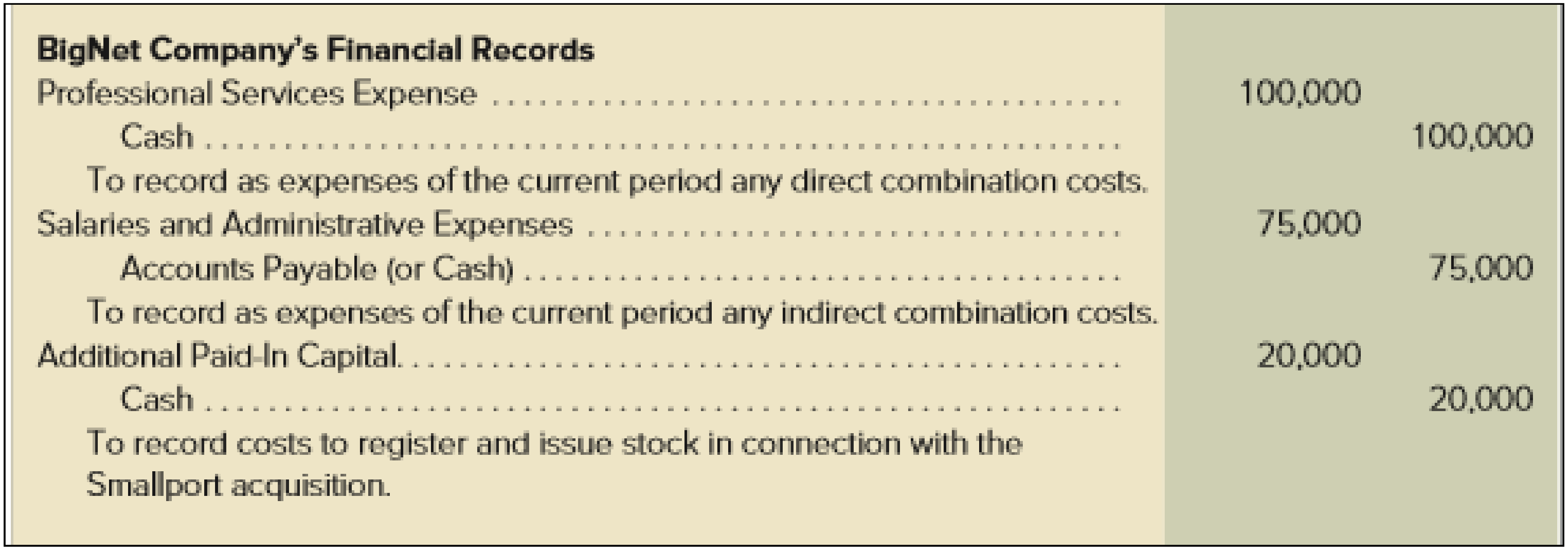
Related Costs of Business Combinations

Three additional categories of costs are incurred in business combinations, regardless of whether dissolution takes place:

1. Attorneys, accountants, investment bankers, and other professionals engaged for combination-related services. These service fees are expensed in the period incurred.
2. An acquiring firm's internal costs (secretarial and management time allocated to the acquisition activity). Such indirect costs are reported as current year expenses, too.
3. Amounts incurred to register and issue securities in connection with a business combination simply reduce the otherwise determinable fair value of those securities.

Journal Entry to Record Related Costs of Business Combinations

Regardless of whether dissolution occurs or separate incorporation is maintained, BigNet records these transactions as follows:



BigNet Company's Financial Records

Professional Services Expense	100,000	
Cash		100,000
To record as expenses of the current period any direct combination costs.		
Salaries and Administrative Expenses	75,000	
Accounts Payable (or Cash)		75,000
To record as expenses of the current period any indirect combination costs.		
Additional Paid-In Capital.	20,000	
Cash		20,000
To record costs to register and issue stock in connection with the Smallport acquisition.		

Learning Objective 2-6c

Prepare the journal entry to record a business combination when the acquired firm retains its separate existence.

The Acquisition Method When Separate Incorporation Is Maintained

Significant differences are evident in combinations in which each company remains a legally incorporated separate entity.

1. **Consolidation of the financial information is only simulated.**
2. **Acquiring company does not physically record the acquired assets and liabilities.**
3. **Dissolution does not occur; each company maintains independent record-keeping.**
4. **To facilitate the preparation of consolidated financial statements, a worksheet and consolidation entries are employed using data gathered from these separate companies although neither company ever records consolidation worksheet entries in its journals.**

Acquisition Method—Subsidiary Is Not Dissolved

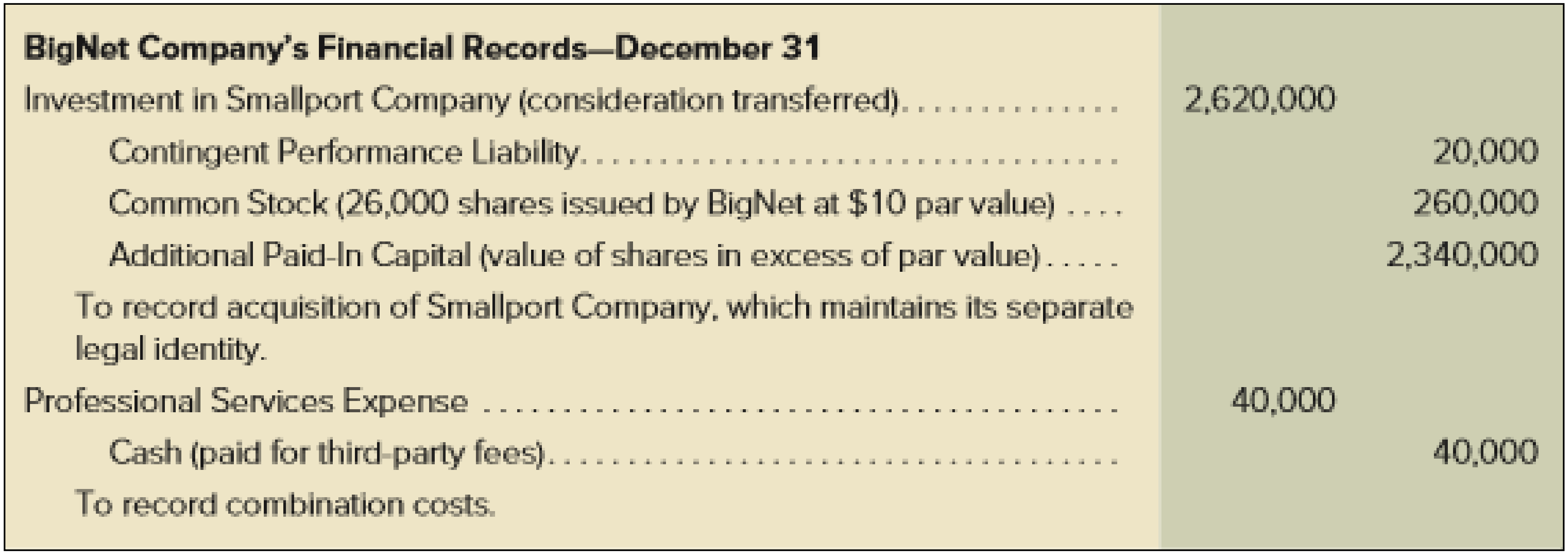
BigNet acquires Smallport Company on December 31 by issuing 26,000 shares of $10 par value common stock valued at $100 per share. BigNet pays fees of $40,000 to a third party for its assistance.

BigNet promises to pay an additional $83,200 to the former owners if Smallport’s earnings exceed $300,000 during the next annual period, with an expected present value of $20,000 for the contingent liability as shown below.

Fair value of securities issued by BigNet.	$2,600,000
Fair value of contingent performance liability	20,000
Total fair value of consideration transferred.	$2,620,000

Acquisition Method—Subsidiary Is Not Dissolved (continued)

When the subsidiary remains separate, the parent establishes an investment account that initially reflects the acquired firm's acquisition-date fair value. Because Smallport maintains its separate identity, BigNet prepares the following journal entries on its books to record the business combination.



BigNet Company's Financial Records—December 31		
Investment in Smallport Company (consideration transferred).	2,620,000	
Contingent Performance Liability.		20,000
Common Stock (26,000 shares issued by BigNet at $10 par value)		260,000
Additional Paid-In Capital (value of shares in excess of par value)		2,340,000
To record acquisition of Smallport Company, which maintains its separate legal identity.		
Professional Services Expense	40,000	
Cash (paid for third-party fees).		40,000
To record combination costs.		

Learning Objective 2-7

Prepare a worksheet to consolidate the financial statements of two companies that form a business combination in the absence of dissolution.

Acquisition Method—Consolidation Workpaper Example

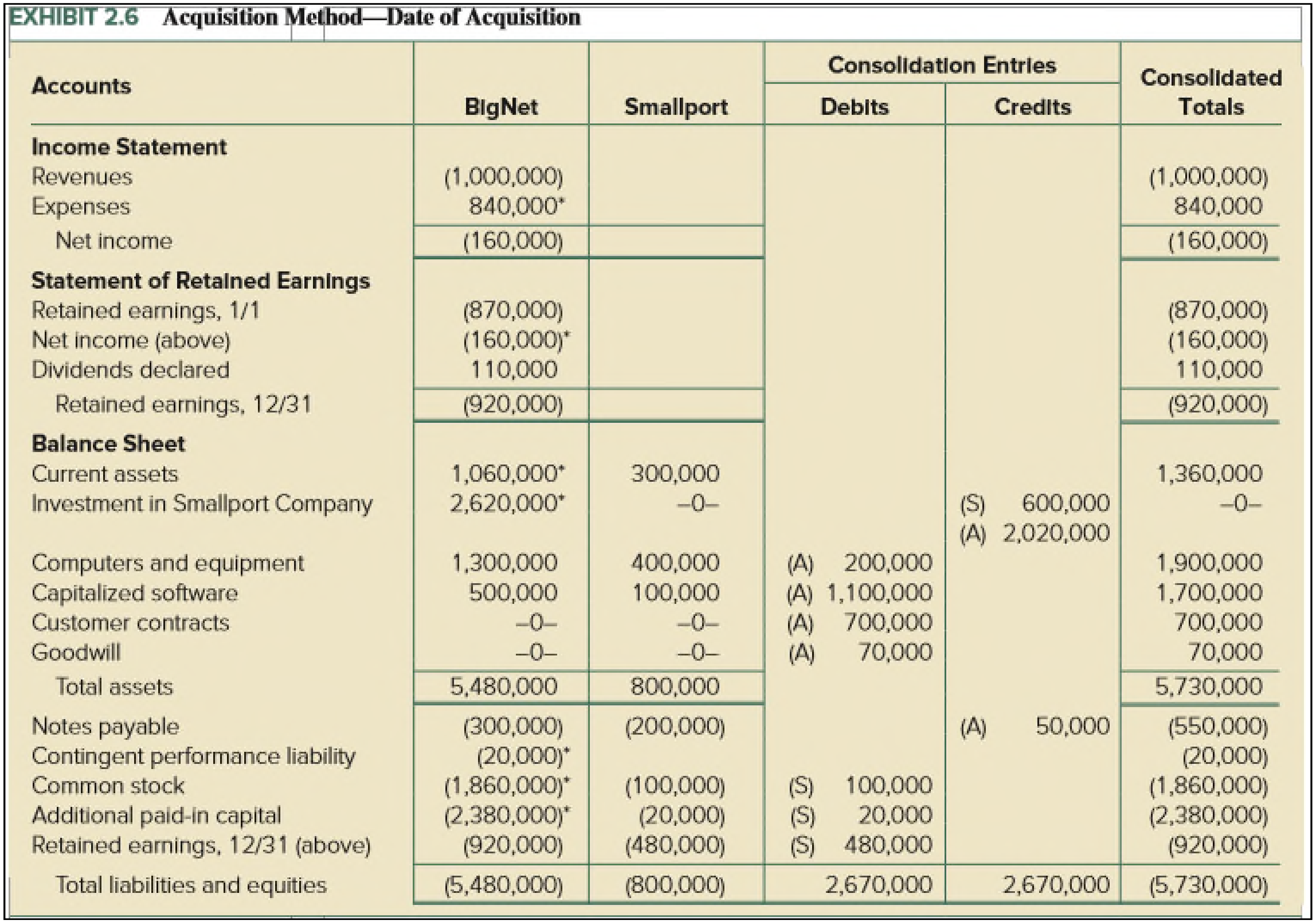


EXHIBIT 2.6 **Acquisition Method—Date of Acquisition**

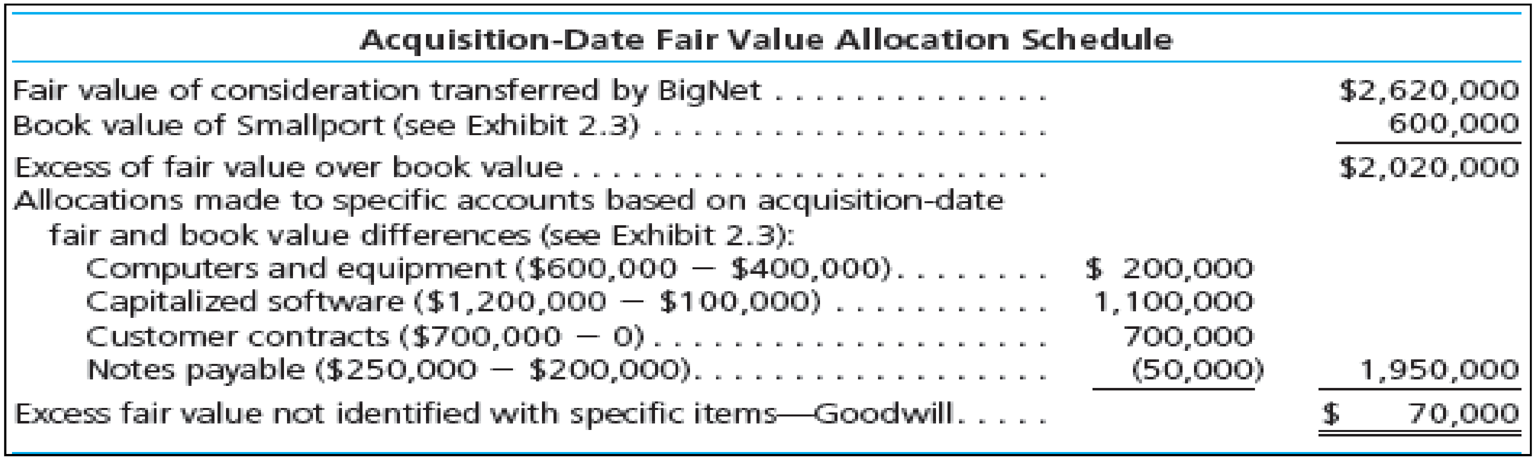
Accounts	BigNet	Smallport	Consolidation Entries		Consolidated Totals
			Debits	Credits	
Income Statement					
Revenues	(1,000,000)				(1,000,000)
Expenses	840,000*				840,000
Net income	(160,000)				(160,000)
Statement of Retained Earnings					
Retained earnings, 1/1	(870,000)				(870,000)
Net income (above)	(160,000)*				(160,000)
Dividends declared	110,000				110,000
Retained earnings, 12/31	(920,000)				(920,000)
Balance Sheet					
Current assets	1,060,000*	300,000			1,360,000
Investment in Smallport Company	2,620,000*	–0–		(S) 600,000 (A) 2,020,000	–0–
Computers and equipment	1,300,000	400,000	(A) 200,000		1,900,000
Capitalized software	500,000	100,000	(A) 1,100,000		1,700,000
Customer contracts	–0–	–0–	(A) 700,000		700,000
Goodwill	–0–	–0–	(A) 70,000		70,000
Total assets	5,480,000	800,000			5,730,000
Notes payable	(300,000)	(200,000)		(A) 50,000	(550,000)
Contingent performance liability	(20,000)*				(20,000)
Common stock	(1,860,000)*	(100,000)	(S) 100,000		(1,860,000)
Additional paid-in capital	(2,380,000)*	(20,000)	(S) 20,000		(2,380,000)
Retained earnings, 12/31 (above)	(920,000)	(480,000)	(S) 480,000		(920,000)
Total liabilities and equities	(5,480,000)	(800,000)	2,670,000	2,670,000	(5,730,000)

Consolidation Worksheet Entries

Consolidation worksheet entries (adjustments and eliminations) are entered on the worksheet only.

Steps in the process:

1. **Prior to constructing a worksheet, the parent prepares a formal allocation of the acquisition-date fair value similar to the equity method procedures.**



Acquisition-Date Fair Value Allocation Schedule

Fair value of consideration transferred by BigNet		$2,620,000
Book value of Smallport (see Exhibit 2.3)		600,000
Excess of fair value over book value		$2,020,000
Allocations made to specific accounts based on acquisition-date fair and book value differences (see Exhibit 2.3):		
Computers and equipment ($600,000 − $400,000).	$ 200,000	
Capitalized software ($1,200,000 − $100,000)	1,100,000	
Customer contracts ($700,000 − 0)	700,000	
Notes payable ($250,000 − $200,000).	(50,000)	1,950,000
Excess fair value not identified with specific items—Goodwill.		$ 70,000

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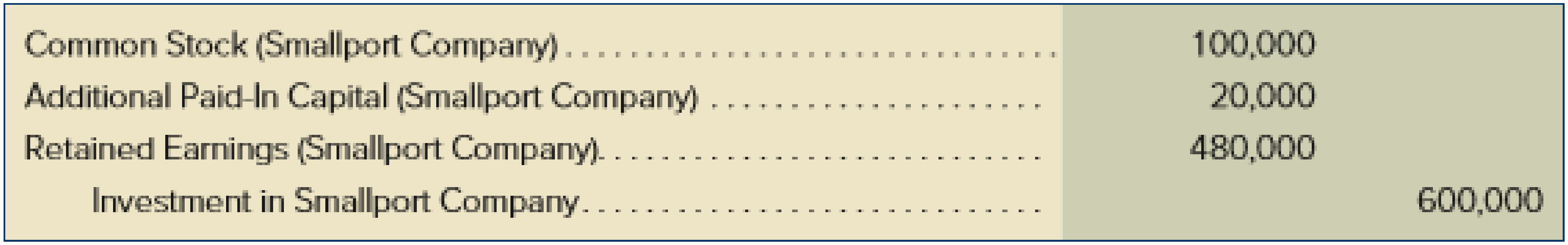
Consolidation Worksheet Entries (continued)

2. Acquisition-date financial information for parent (after journal entry for the investment and combination costs) and sub is recorded in the first two columns of the worksheet (sub's prior revenue and expense already closed).
3. Remove the sub's equity account balances and remove the Investment in Sub balance (Entry S).
4. Remove the excess payment in the investment account at acquisition date and assign it to the specific accounts indicated by the fair-value allocation schedule (Entry A).

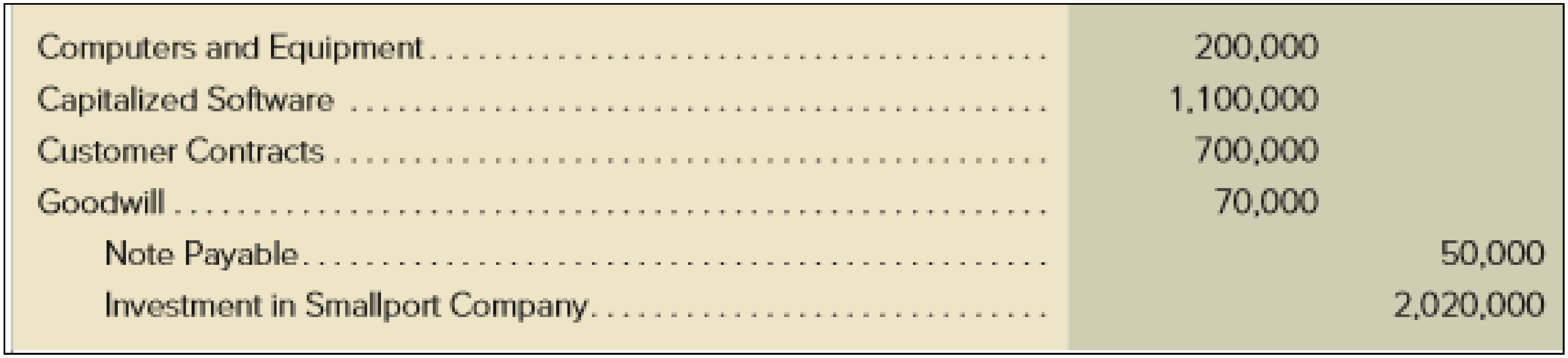
Acquisition Method—Consolidation Workpaper Journal Entries

Consolidation Entry S



Common Stock (Smallport Company)	100,000	
Additional Paid-In Capital (Smallport Company)	20,000	
Retained Earnings (Smallport Company)	480,000	
Investment in Smallport Company		600,000

Consolidation Entry A



Computers and Equipment	200,000	
Capitalized Software	1,100,000	
Customer Contracts	700,000	
Goodwill	70,000	
Note Payable		50,000
Investment in Smallport Company		2,020,000

Consolidation Worksheet Entries (concluded)

5. Combine all account balances and extend into the Consolidated Totals column.
6. Subtract consolidated expenses from revenues to arrive at net income.

Learning Objective 2-8

Describe the accounting treatment for the various intangible assets often acquired in a business combination.

Acquisition-Date Fair-Value Allocations

In determining whether to recognize an intangible asset in a business combination, two specific criteria are essential. Intangible assets:

- Arise from contractual or other legal rights (most intangibles in business combinations meet the contractual-legal criterion).
- Are capable of being sold or otherwise separated from the acquired enterprise.

Intangible Assets That Meet the Criteria for Recognition Separately from Goodwill

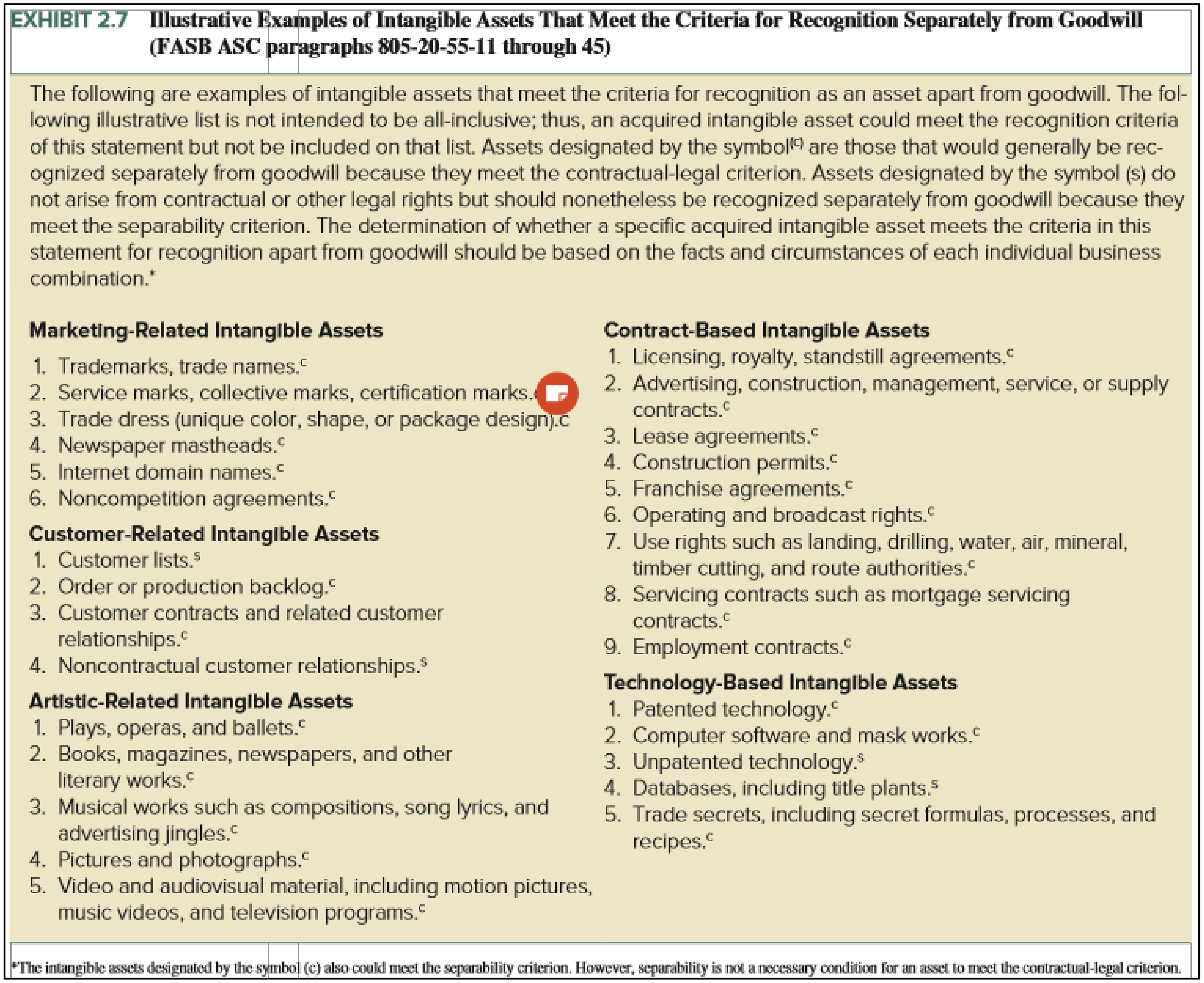


EXHIBIT 2.7 **Illustrative Examples of Intangible Assets That Meet the Criteria for Recognition Separately from Goodwill (FASB ASC paragraphs 805-20-55-11 through 45)**

The following are examples of intangible assets that meet the criteria for recognition as an asset apart from goodwill. The following illustrative list is not intended to be all-inclusive; thus, an acquired intangible asset could meet the recognition criteria of this statement but not be included on that list. Assets designated by the symbol$^{(c)}$ are those that would generally be recognized separately from goodwill because they meet the contractual-legal criterion. Assets designated by the symbol (s) do not arise from contractual or other legal rights but should nonetheless be recognized separately from goodwill because they meet the separability criterion. The determination of whether a specific acquired intangible asset meets the criteria in this statement for recognition apart from goodwill should be based on the facts and circumstances of each individual business combination.*

Marketing-Related Intangible Assets

1. Trademarks, trade names.^{c}
2. Service marks, collective marks, certification marks.
3. Trade dress (unique color, shape, or package design).c
4. Newspaper mastheads.^{c}
5. Internet domain names.^{c}
6. Noncompetition agreements.^{c}

Customer-Related Intangible Assets

1. Customer lists.^{s}
2. Order or production backlog.^{c}
3. Customer contracts and related customer relationships.^{c}
4. Noncontractual customer relationships.^{s}

Artistic-Related Intangible Assets

1. Plays, operas, and ballets.^{c}
2. Books, magazines, newspapers, and other literary works.^{c}
3. Musical works such as compositions, song lyrics, and advertising jingles.^{c}
4. Pictures and photographs.^{c}
5. Video and audiovisual material, including motion pictures, music videos, and television programs.^{c}

Contract-Based Intangible Assets

1. Licensing, royalty, standstill agreements.^{c}
2. Advertising, construction, management, service, or supply contracts.^{c}
3. Lease agreements.^{c}
4. Construction permits.^{c}
5. Franchise agreements.^{c}
6. Operating and broadcast rights.^{c}
7. Use rights such as landing, drilling, water, air, mineral, timber cutting, and route authorities.^{c}
8. Servicing contracts such as mortgage servicing contracts.^{c}
9. Employment contracts.^{c}

Technology-Based Intangible Assets

1. Patented technology.^{c}
2. Computer software and mask works.^{c}
3. Unpatented technology.^{s}
4. Databases, including title plants.^{s}
5. Trade secrets, including secret formulas, processes, and recipes.^{c}

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*The intangible assets designated by the symbol (c) also could meet the separability criterion. However, separability is not a necessary condition for an asset to meet the contractual-legal criterion.

Acquisition-Date Fair-Value Allocations—Additional Issues

- Preexisting goodwill recorded in the acquired company's accounts is ignored in the acquisition-date fair value. Goodwill is recognized only if excess remains after recognizing fair values of net identified assets.
- Acquired IPR&D (acquired businesses to in-process research and development) is measured at acquisition-date fair value, recognized as an asset, and tested for impairment. It is not amortized until its useful life is determined to be no longer indefinite.

Convergence between U.S. and International Accounting Standards

- **FASB Project Updates: *Business Combinations: Applying the Acquisition Method—Joint Project of the IASB and FASB*: October 25, 2007) goal was to develop a standard with a common set of principles and guidance.**
- **IASB International Financial Reporting Standard 3 (*IFRS 3)* Revised and FASB ASC Topics 805, "Business Combinations," and 810, "Consolidation," effectively converged accounting for business combinations.**

Learning Objective 2-9

Appendix 2A: Identify the general characteristics of the legacy purchase and pooling of interest methods of accounting for past business combinations. Understand the effects that persist today in financial statements from the use of these legacy methods.

Appendix A: Legacy Methods of Accounting for Business Combinations

Since the ACQUISITION METHOD is applied to business combinations occurring in 2009 and after, the two prior methods are still in use.

- **2002 to 2008: Purchase Method**
- **Prior to 2002: Purchase Method or Pooling of Interests Method**

Purchase Method: An Application of the Cost Principle

How the cost-based purchase method differs from the fair-value-based acquisition method:

- **Acquisition date allocations (including bargain purchases).**
- **Direct combination costs.**
- **Contingent consideration.**
- **In-process R&D.**

Purchase-Date Cost Allocations (Including Bargain Purchases)

- The purchase method based its cost allocations on the combination-date fair values of the acquired assets and liabilities.
- Excess of cost over the sum of the net identified asset fair values was attributed to goodwill.
- A bargain purchase occurred when the sum of the individual fair values of the acquired net assets exceeded the purchase cost.
- To record a bargain purchase at cost, however, the purchase method required that certain long-term assets be recorded at amounts below their assessed fair values.

Purchase-Date Cost Allocations (Including Bargain Purchases) (continued)

- Acquirer measures and recognizes fair values of each of the assets acquired and liabilities assumed at the date of combination, regardless of consideration transferred. Therefore:
  - No assets are recorded at amounts below their assessed fair values, as is the case with bargain purchases accounted for by the purchase method.
  - A gain on bargain purchase is recognized at the acquisition date.

Direct Combination Costs and Contingent Consideration

- Under the purchase method, the investment cost basis included direct combination costs for professional services to assist in various phases of the transaction.
- Contingent consideration obligations arising from agreements to provide additional payments to former owners if they meet specified future performance measures are accounted for as postcombination adjustments to the purchase cost (or stockholders' equity if the parent's equity share value is involved) upon resolution of the contingency.

In-Process Research and Development

- Under the purchase method, financial reporting standards required immediate expensing of acquired IPR&D if the project had not yet reached technological feasibility and the assets had no future alternative uses.
- Expensing acquired IPR&D was consistent with the accounting treatment for a firm's ongoing research and development costs.

The Pooling of Interests Method: Continuity of Previous Ownership

- Under the pooling of interests method, owners of separate firms agreed to combine for mutual benefit and continue as owners of a combined firm.
- Assets and liabilities were never bought or sold. Owners exchanged ownership shares to become joint owners of the combined firm.
- One ownership group did not replace another. The method assured continuity of ownership interests before and after the business combination.

The Pooling of Interests Method Process

Two important steps characterized the pooling of interests method:

1. **The book values of the assets and liabilities of both companies became the book values reported by the combined entity.**
2. **The revenue and expense accounts were combined retrospectively as well as prospectively. The idea of continuity of ownership gave support for the recognition of income accruing to the owners both before and after the combination.**

Pooling of Interests Review

- Reported income was typically higher than under the purchase accounting method.
- There was less depreciation and amortization expense due to the smaller asset bases.
- Prior to 2002, both the purchase and pooling of interest methods were allowed.
- New standards set strict criteria for use of the pooling method.
- If business combinations failed to meet the criteria, they had to be accounted for by the purchase method.

Pooling of Interests Criteria

Objectives of the criteria:

1. To ensure complete fusion of the two organizations, one company had to obtain substantially all (90 percent or more) of the voting stock of the other.
2. To prevent purchase combinations from being disguised as poolings.

Past experience had shown that combination transactions were frequently manipulated so that they would qualify for pooling of interests treatment (usually to increase reported earnings). A number of qualifying criteria for pooling of interests treatment were designed to stop this practice.

Characteristics of the Purchase Method

Characteristics of the purchase method:

- Valuation basis is cost and includes direct combination costs but excludes the contingent consideration.
- Cost is allocated to the assets acquired and liabilities assumed based on their individual fair values (unless a bargain purchase occurs and then the long-term items may be recorded as amounts less than their fair values).
- Goodwill is the excess of cost over the fair values of the net assets purchased.
- Acquired in-process research and development is expensed immediately at the purchase date.

Characteristics of the Pooling of Interests Method

Characteristics of the pooling of interests method:

- Accounting incorporated a continuation of previous book values and ignored fair values exchanged in a business combination.
- Previously unrecognized (typically internally developed) intangibles continue to be reported at a zero value postcombination.
- Values an acquired firm at its previously recorded book value, so no new amount for goodwill was ever recorded in a pooling.

Characteristics of the Acquisition Method

Characteristics of the acquisition method:

- Valuation basis is fair value of consideration transferred and includes the contingent consideration but excludes direct combination costs.
- Assets acquired and liabilities assumed are recorded at their individual fair values.
- Goodwill is the excess of the consideration transferred over the fair values of the net assets acquired.
- Acquired in-process research and development is recognized as an asset.
- Professional service fees to help accomplish the acquisition are expensed.

Learning Objective 2-10

Appendix 2B: Explain the rationale and procedures underlying a subsidiary’s election to adopt pushdown accounting.

Appendix B: Pushdown Accounting—External Reporting

To address valuation issues for a subsidiary’s separately issued financial statements, the FASB issued Accounting Standards Update (ASU) No. 2014-17, *Business Combinations: Pushdown Accounting*, in November 2014. The ASU:

- Does not require pushdown accounting when the acquired firm maintains separate incorporation.
- Provides an option to apply pushdown accounting following a business combination in which the acquirer obtains control of an acquired entity and the acquired entity maintains separate incorporation.

If pushdown accounting is used, the parent’s acquisition date valuations are “pushed down” to the subsidiary’s financial statements.

Pushdown Accounting—Other Issues

- **Goodwill: Goodwill recognized in the combination is reported in the acquired entity's separate financial statements.**
- **Bargain purchase gains: The acquired entity does not recognize the gain in its income statement but as an adjustment to its additional paid-in capital.**
- **Acquisition-related liabilities: Only the debt for which the acquired firm is jointly or severally liable must be recognized.**
- **Acquisition-date subsidiary retained earnings: Company is recognized as a new reporting entity. Acquired firm reports zero acquisition-date retained earnings.**

Pushdown Accounting—Internal Reporting

Pushdown accounting has several advantages for internal reporting.

- **It simplifies the consolidation process.**
- **Amortizations of the excess fair value allocation would be incorporated in subsequent periods as well.**
- **Pushdown accounting does not address the many issues in preparing consolidated financial statements.**