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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.

The consideration transferred includes cash, securities, and contingent performance obligations.

Direct combination costs are expensed as incurred.

Stock issuance costs are recorded as a reduction in paid-in capital.

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:

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.

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

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.

When push-down accounting is elected,

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).

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.

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

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:

Net income (adjusted for professional services expense. The figures earned by the subsidiary prior to the takeover are not included)	$ 210,000
Retained earnings, 1/1 (the figures earned by the subsidiary prior to the takeover are not included)	800,000
Patented technology (the parent's book value plus the fair value of the subsidiary)	1,180,000
Goodwill (computed above)	50,000
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
Common stock (the parent's book value after recording the newly-issued shares)	510,000
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

Accounts	Marshall Company*	Tucker Company	Consolidation Entries Debit	Consolidation Entries Credit	Consolidated 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			54,0 0
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:

	Debit	Credit
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)		

	Debit	Credit
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) NEWTUNE, INC., AND ON-THE-GO CO.

b. Consolidation Worksheet

January 1, 2018

Accounts	NewTune, Inc.	On-the-Go Co.	Consolidation Entries Debit	Consolidation Entries Credit	Consolidated 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:

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.

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.

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.

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.

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.

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.

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)

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.

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

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.

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.

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.

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)

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.

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

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.