Lectures In : Specialized Accounting
Second Year – English Section
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lecture

Accounting for Business Combinations

Treatment of Acquisition Expenses

FASB ASC paragraph 805-10-25-23 excludes acquisition-related from measurement of consideration paid.

- both **direct** and **indirect** costs are **expensed**
- the cost of issuing securities is also excluded from the consideration.

  Security issuance costs are *assigned to the valuation of the security*, thus reducing the additional contributed capital for stock issues or adjusting the premium or discount on bond issues.

LO 4 Reporting acquisition expenses.

Perspective on Business Combinations

Acquisition Costs—an Example:

Suppose that SMC Company acquires 100% of the net assets of Bee Company (net book value of $100,000) by issuing shares of common stock with a fair value of $120,000. With respect to the merger, SMC incurred $1,500 of accounting and consulting costs and $3,000 of stock issue costs. SMC maintains a mergers department that incurred a monthly cost of $2,000. Prepare the journal entry to record these direct and indirect costs.

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

LO 4 Reporting acquisition expenses.

Pro Forma Statements and Disclosure Requirement

Pro forma statements serve two functions in relation to business combinations:

1) to provide information in the ***planning*** stages of the combination and

2) to ***disclose*** relevant information subsequent to the combination.

LO 5 Use of pro forma statements.

Pro Forma Statements and Disclosure Requirement

P Company Pro Forma Balance Sheet
Giving Effect to Proposed Issue of Common Stock for All the Net Assets of S Company January 1, 2012

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

Illustration 2-1

LO 5 Use of pro forma statements.

Pro Forma Statements and Disclosure Requirement

If a material business combination occurred, ***notes*** to financial statements should include on a pro forma basis:

1. Results of operations for the current year as though the companies had combined at the beginning of the year.

2. Results of operations for the immediately preceding period as though the companies had combined at the beginning of that prior period if comparative financial statements are presented.

LO 5 Use of pro forma statements.

Explanation and Illustration of Acquisition Accounting

Four steps in the accounting for a business combination:

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

Explanation and Illustration of Acquisition Accounting

Value of Assets and Liabilities Acquired

- Identifiable assets acquired (including intangibles other than goodwill) and liabilities assumed should be recorded at their **fair values** at the date of acquisition.
- Any excess of total cost over the sum of amounts assigned to identifiable assets and liabilities is recorded as goodwill.
- Under current GAAP, in-process R&D is measured and recorded at fair value as an asset on the acquisition date.

LO 6 Valuation of acquired assets and liabilities assumed.

Explanation and Illustration of Acquisition Accounting

E2-1: Preston Company acquired the assets (except for cash) and assumed the liabilities of Saville Company. Immediately prior to the acquisition, Saville Company's balance sheet was as follows:

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

Any Goodwill?

LO 6 Valuation of acquired assets and liabilities assumed.

Explanation and Illustration of Acquisition Accounting

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Fair value of assets, without cash $1,824,000

LO 6 Valuation of acquired assets and liabilities assumed.

Explanation and Illustration of Acquisition Accounting

E2-1: **A.** Prepare the **journal entry** on the books of Preston Co. to record the purchase of the assets and assumption of the liabilities of Saville Co. if the amount paid was $1,560,000 in cash.

Calculation of Goodwill

Fair value of assets, without cash	$1,824,000
Fair value of liabilities	594,000
Fair value of net assets	1,230,000
Price paid	1,560,000
Goodwill	$ 330,000

LO 6 Valuation of acquired assets and liabilities assumed.

Explanation and Illustration of Acquisition Accounting

E2-1: **A.** Prepare the **journal entry** on the books of Preston Co. to record the purchase of the assets and assumption of the liabilities of Saville Co. if the amount paid was $1,560,000 in cash.

Receivables	228,000	
Inventory	396,000	
Plant and equipment	540,000	
Land	660,000	
Goodwill	330,000	
Liabilities		594,000
Cash		1,560,000

LO 6 Valuation of acquired assets and liabilities assumed.

Explanation and Illustration of Acquisition Accounting

Bargain Purchase

When the fair values of identifiable net assets (assets less liabilities) **exceeds** the total cost of the acquired company, the acquisition is a **bargain**.

- In the past, FASB required that most long-lived assets be written down on a pro rata basis before recognizing a gain.
- Current standards require:
  - fair values be considered carefully and adjustments made as needed.
  - any excess of acquisition-date fair value of net assets over the consideration paid is recognized in income.

LO 6 Valuation of acquired assets and liabilities assumed.

Explanation and Illustration of Acquisition Accounting

Bargain Acquisition Illustration

When the price paid to acquire another firm is lower than the fair value of identifiable net assets (assets minus liabilities), the acquisition is referred to as a **bargain**.

- Any previously recorded goodwill on the seller's books is eliminated (and no new goodwill recorded).
- A gain is reflected in current earnings of the acquiree to the extent that the fair value of net assets exceeds the consideration paid.

LO 6 Valuation of acquired assets and liabilities assumed.

Explanation and Illustration of Acquisition Accounting

E2-1: B. Repeat the requirement in (A) assuming that the amount paid was $990,000.

Calculation of Goodwill or Bargain Purchase

Fair value of assets, without cash	$1,824,000
Fair value of liabilities	594,000
Fair value of net assets	1,230,000
Price paid	990,000
Bargain purchase	**$ 240,000**

LO 6 Valuation of acquired assets and liabilities assumed.

Explanation and Illustration of Acquisition Accounting

E2-1: B. Repeat the requirement in (A) assuming that the amount paid was $990,000.

Receivables	228,000	
Inventory	396,000	
Plant and equipment	540,000	
Land	660,000	
Liabilities		594,000
Cash		990,000
Gain on acquisition (ordinary)		240,000

LO 6 Valuation of acquired assets and liabilities assumed.