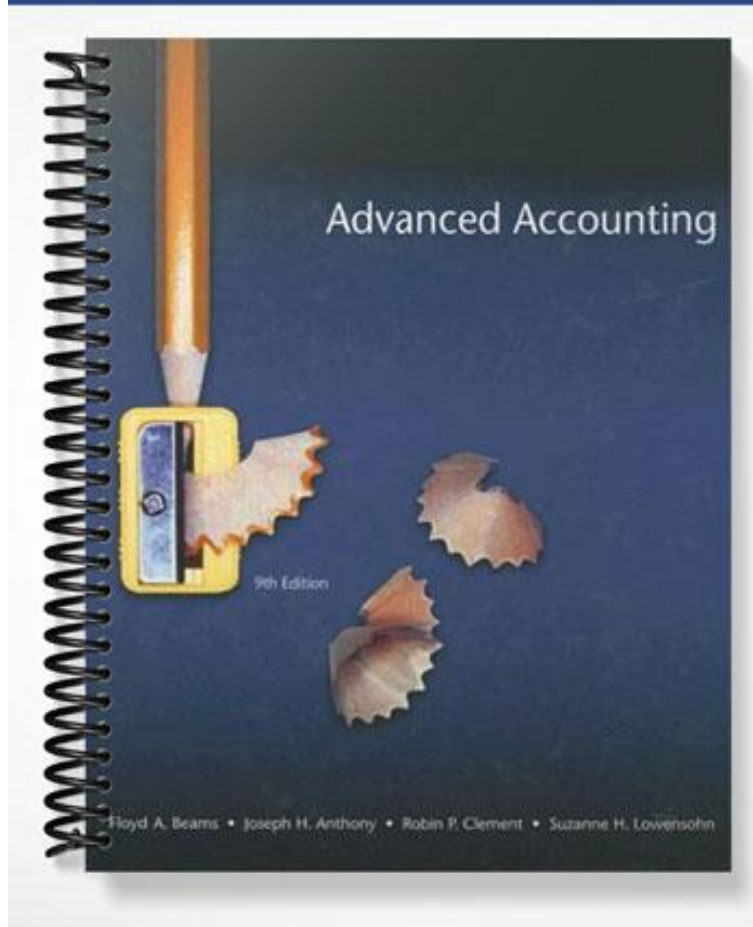
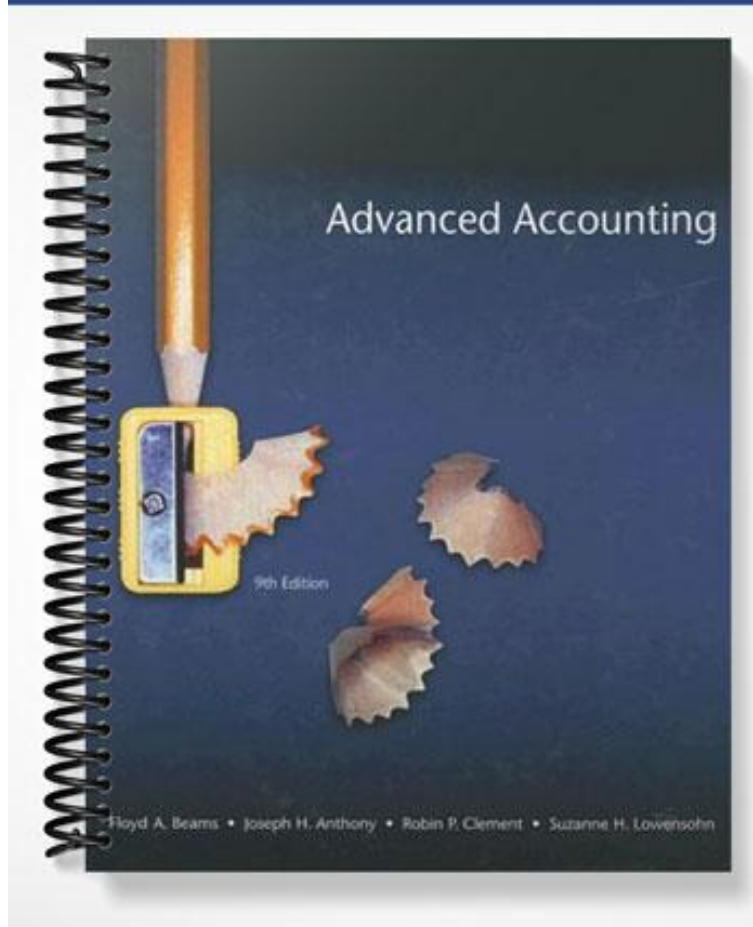


SOLUTIONS MANUAL



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Chapter 1

BUSINESS COMBINATIONS

Comprehensive Chapter Outline

A BUSINESS COMBINATION IS THE UNION OF PREVIOUSLY SEPARATE BUSINESS ENTITIES.

- A** Horizontal integration is the combination of firms in the same business lines and markets.
- B** Vertical integration is the combination of firms with operations in different, but successive, stages of production and/or distribution.
- C** Conglomeration is the combination of firms with unrelated and diverse products and/or service functions.
- D** Businesses may elect to expand through business combination rather than constructing new facilities or developing new products for a variety of reasons including lower costs reduced risks, fewer operating delays, avoidance of takeovers, acquisition of intangible assets, and tax advantages.

ANTITRUST LAWS PROHIBIT BUSINESS COMBINATIONS THAT WOULD BE IN RESTRAINT OF TRADE OR WOULD IMPAIR COMPETITION.

- A** Proposed business combinations are reviewed by federal agencies such as the Justice Department, the Federal Trade Commission, the Federal Reserve Board, the Department of Transportation, and the Securities and Exchange Commission.
- B** State agencies review business combinations for possible violations of state statutes.

DEFINITIONS:

- A** Acquisition occurs when:
 - 1 One corporation acquires the productive assets of another business entity and integrates those assets into its own operations, or
 - 2 One corporation obtains operating control over the productive facilities of another entity by acquiring a majority of its outstanding voting stock.
- B** Merger, in a technical sense, occurs when one corporation takes over all the operations of another business entity and that entity is dissolved.
- C** Consolidation, in a technical sense, occurs when a new corporation is formed to take over the assets and operations of two or more separate business entities and all the combining companies are dissolved.

- D** Business combination, as an accounting concept, occurs when a corporation and one or more incorporated or unincorporated businesses are brought together under the control of a single management team. That control is established when:
- 1** One corporation becomes a subsidiary (i.e., when another corporation acquires a controlling interest of its outstanding voting stock),
 - 2** One company transfers its net assets to another, or
 - 3** Each company transfers its net assets to a newly formed corporation.
- E** Merger, consolidation, and acquisition are often used in a generic sense as synonyms for business combinations. The term "consolidation" also refers to the accounting process of combining a parent company's financial statements with those of its subsidiaries.

FASB STATEMENT 141, BUSINESS COMBINATIONS, REVISES THE REQUIREMENTS FOR ACCOUNTING FOR BUSINESS COMBINATIONS.

A Major conclusions – In May, 2001, the FASB issued Statement 141 which reaffirmed the business combination concept with the following exception:

- 1** The pooling of interest method of accounting was eliminated for all transactions initiated after June 30, 2001.
- 2** Prior combinations accounted for by the pooling of interests method will be allowed to continue as acceptable financial reporting practice for past business combinations.
- 3** FASB Statement 141 makes U. S. GAAP more consistent with international accounting standards. Most major economies, including France, Japan, and Germany prohibit the use of pooling of interests accounting

B Application of the purchase method:

- 1** Cost in a purchase business combination is measured by the cash disbursed, or the fair value of property given up, or securities issued.
- 2** Direct costs of acquisition:
 - a** Direct costs of registering and issuing securities are charged against additional paid-in capital.
 - b** Other direct costs of combining are included in the cost of the acquired company.

- c** Indirect costs and costs to close duplicate facilities are expensed.

3 Cost allocation procedures

- a** Determine the fair values of all identifiable tangible and intangible assets acquired and liabilities assumed.
- b** FASB Statement 141 provides specific guidelines for valuing assets and liabilities.
- c** All identifiable assets and liabilities are valued regardless of whether they are recorded on the books of the acquired company.
- d** Defined benefit pension plans should require a liability (projected benefit obligation in excess of plan assets) or an asset (amount of plan assets in excess of the projected benefit obligation).
- e** No value is assigned to goodwill on the books of the acquired company.
- f** Preacquisition contingencies other than the tax benefit of a loss carryforward, should have their fair market value included in allocating the purchase price. If fair market value cannot be determined, amounts that can be reasonably estimated for probable contingencies should be included.

4 The acquiring company records the assets received and liabilities assumed at their fair values.

- a** First, fair values are assigned to all identifiable tangible and intangible assets acquired and liabilities assumed.
- b** If cost is greater than fair value of the identifiable net assets acquired, the excess is goodwill.
- c** If fair value is greater than cost, the excess fair value is **negative goodwill** and handled in the following fashion:

(1) The excess is applied as a pro rata reduction of amounts that would have been assigned to assets except for financial assets other than investments accounted for by the equity method, assets to be disposed of, deferred tax assets, prepaid pension and post-retirement assets, and any other current assets.

(2) The remainder, if any, is recognized as an extraordinary gain.

5 Recognition and measurement of intangible assets other than goodwill

- a** Intangible assets other than goodwill will be recognized if they meet either a separability criterion or a contractual-legal criterion.
- b** Intangible assets that cannot be identified should be included in goodwill.
- c** See Exhibit 1-2 in the text for a listing of intangible assets that meet the criterion as an asset apart from goodwill.

6 Contingent Consideration in a Purchase Business Combination

- a** Contingent consideration is an additional payment made to the previous stockholders of the acquired company contingent on future events or transactions. The contingent consideration may include the distribution of cash, other assets, or the issuance of debt or equity securities.
- b** Contingent consideration that is determinable at the date of acquisition is recorded as part of the cost of the combination.
- c** Contingent consideration that is not determinable at the date of acquisition is recorded when the contingency is resolved and the consideration is issued or becomes issuable.
- d** A contingency involving future earnings levels is recognized at fair market value as an additional cost of the acquired company. This is recognized as goodwill.
- e** If the contingency is based on security prices, the recorded cost of the acquired company should not change. When the contingency is resolved, the fair market value of the consideration is applied as a reduction to securities issued and recorded at the date of acquisition proportionately.

7 Financial reporting

- a** The retained earnings is that of the surviving entity (or parent).
- b** Income is the income of the surviving company up to the date of combination plus combined income after combination.

8 The use of different accounting methods by the combining companies is not an issue because the assets and liabilities of the acquired company are recorded at fair values.

9 Disclosures to be made in the financial statements for a purchase:

- a** The business combination was a purchase.
- b** The name and a brief description of the acquired company.
- c** The period for which the results of operations of the acquired company are included in the income statement.
- d** The cost of the acquired company, including when applicable, the number and value of shares of stock issued or issuable.
- e** A description of any contingent payments.
- f** Several small acquisitions may be combined for disclosure purposes.
- g** For material acquisitions of public companies, the following supplemental information on a pro forma basis is required:
 - (1) The results of operations for the current period as though the companies had combined at the beginning of the period, and
 - (2) The results of operations for the immediately preceding period as though the companies had combined at the beginning of that period if comparative financial statements are presented.
- h** Additional required FASB Statement 141 disclosures include:
 - (1) primary business reason for the combination
 - (2) allocation of the purchase price by major balance sheet categories for assets acquired and liabilities assumed
- i** FASB Statement 142 requires:
 - (1) material aggregate amounts of goodwill as a separate balance sheet item
 - (2) impairment losses must be shown separately on the income statement
 - (3) increased disclosures for intangibles (See text Exhibit 1-3)

THE GOODWILL CONTROVERSY

- A** Goodwill is defined as the excess of the investment cost over the fair value of assets received.
- B** Goodwill is no longer amortized for financial reporting purposes
- C** Firms must periodically assess goodwill for impairment in its value. An impairment occurs when the recorded value is less than its fair value.
 - 1 When an impairment occurs, firms must write down goodwill to a new estimated amount and record a loss in calculating net income of a period.
 - 2 The treatment of goodwill has not retroactively changed, but firms will cease amortizing all previously recorded goodwill.
 - 3 Goodwill and all other intangibles that have indefinite useful lives will be periodically reviewed and adjusted for value impairment.
 - 4 Impairment losses on goodwill and other intangible assets will be considered a loss due to a change in accounting principle the first time it is recognized.
- D** The standard also redefines the reporting entity in accounting for intangible assets. Firms will treat goodwill and other intangible assets as assets of the business reporting unit, not a stand alone reporting entity.
 - 1 These intangible assets will be reported based on their fair value at acquisition date.
- E** Internally developed intangibles will not be recognized as an asset, but expensed and the same treatment will continue for acquired research and development costs.
- F** Recognizing and measuring impairment losses
 - 1 This is a two- step process. Step one compares book values to fair values at the business reporting unit level. If fair value is less than book value, proceed to step two, measurement of the impairment loss.
 - 2 The book value of goodwill is compared to its implied fair value. The impairment loss is the difference. The loss cannot exceed the book value of the goodwill. Previously recognized impairment losses cannot be reversed.
 - 3 The impairment test should be conducted annually and can be more frequent if certain conditions warrant.

G Amortization versus non-amortization

- 1 Amortization is required for intangible assets with a finite useful life.
- 2 The method of amortization should reflect the expected pattern of consumption of the economic benefits of the asset.
- 3 If a pattern is not determinable, straight-line amortization is acceptable.
- 4 Firms will not amortize intangibles with an indefinite life that cannot be estimated. If they later have an estimated life, they should be amortized at that point.

APPENDIX: POOLING OF INTERESTS METHOD FOR BUSINESS COMBINATIONS

A While prohibited under FASB Statement 141, prior business combinations accounted for under the pooling of interests method will continue to exist as acceptable financial reporting practices for past business combinations.

B A pooling of interests combination is based on the assumption that ownership interests of the combining companies are united and continue in the new accounting entity.

- 1 There is no purchase, no purchase price, and no new basis of accountability.
- 2 The assets and liabilities of the combining companies are carried forward to the combined entity at book value.
- 3 Retained earnings of the combining companies are carried forward to the pooled entity subject to certain limitations.
- 4 Income of the pooled entity includes the incomes of the combining companies for the entire year regardless when the combination occurs.
- 5 A change in accounting method to conform the individual methods should be applied retroactively and prior years financial statements should be restated.

C A business combination that met the conditions for a pooling of interests was accounted for as such.

- 1 In a merger or consolidation, there is only one surviving entity which maintains its own accounting records.
- 2 In a parent-subsidiary relationship, the reporting for the combined entity requires the issuance of consolidated financial statements.

- D** In a pooling of interests the financial statements of the surviving (combined) entity are prepared as if the company had been combined as of the beginning of the year.

Description of assignment material	<u>Minutes</u>
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Questions (5)

Exercises (5)

El-1	4 MC general	5
El-2	AICPA 2 MC problem-type	10
El-3	[Pillow/Sleep-bank] Prepare stockholders' equity section	15
El-4	[Ice Age/Jester] Journal entries (recording business combinations)	20
El-5	[Danders/Harrison] Journal entries to record a purchase with direct costs and fair value/book value differences	15

Problems (5)

Pl-1	[Pine/Sain] Prepare balance sheet after purchase business combination	20
Pl-2	[Pelican/Seabird] Prepare balance sheet after purchase business combination	20
Pl-3	[Persis/Sineco] Journal entries and balance sheet for purchase business combination	18
Pl-4	[Phule/Sen] Allocation schedule and balance sheet	25
Pl-5	[Celistia/Dawn] Journal entries and balance sheet for a purchase combination	35

Internet assignment

Using annual reports from the websites of three major publicly traded companies, answer questions regarding merger activity. For one company, review Form 10-K and determine what additional information is disclosed that is not available in the annual report.

ELECTRONIC SUPPLEMENT

POOLING OF INTERESTS ACCOUNTING

The issuance of *FASB Statement 141* eliminates pooling of interests accounting for new business combinations initiated after June 30, 2001. However, poolings initiated before June 30, 2001, may continue into the future.

A Conditions for a pooling of interests:

- 1 Each of the combining companies is autonomous.
 - a Each company has not been a subsidiary or division of another corporation within two years of the date of initiation.
 - b The date of initiation is the earlier of the date of a public announcement of the exchange ratio or the date the stockholders are notified of the exchange ratio.

- 2 The combining companies are independent, with the other combining companies in total owning no more than 10% of the voting stock of the any combining company.
- 3 The combination must be completed in a single transaction or be completed in one year after initiation.
- 4 One corporation must offer and issue only common stock in exchange for substantially all (90% or more) of the outstanding voting stock of another company.
- 5 None of the combining companies change their equity interest in voting common stock in contemplation of combination for two years before initiation of the plan or between the date of initiation and consummation.
- 6 The combining companies reacquire shares only for business purposes other than the combination.
- 7 The proportionate interest of each common stockholder remains the same as a result of the exchange of stock.
- 8 The voting rights in the combined corporation are immediately exercisable by the stockholders.
- 9 The combination is resolved at consummation with no pending provisions.
- 10 The issuing company must not agree to retire or reacquire stock issued to effect the combination.
- 11 The issuing company must not enter into financial agreements to benefit former stockholders of a combining company.
- 12 The combined company must not plan to dispose of significant amounts of assets within two years after the combination. The disposal of duplicate facilities is permitted.

B Application of the pooling of interests method:

- 1 Assets and liabilities are recorded at book values. (Note: Net assets are not affected by the number of shares issued to effect a pooling.)
- 2 The exchange ratio is the ratio of the number of shares of the issuing company I s stock to each share of the combining company I s stock.

- 3 Capital stock is the capital stock of the issuing company (or parent).
- 4 Retained earnings balances are combined.
 - a Maximum pooled retained earnings equals combined retained earnings.
 - b Maximum retained earnings is reduced by any excess of capital stock of the issuing company over total paid-in capital of the combining companies.
 - c If maximum retained earnings is reduced, the pooled entity has no additional paid-in capital.
- 5 The additional paid-in capital of the pooled entity is equal to the excess of total paid-in capital of the combining entities over the capital stock of the issuing company.
- 6 If the separate companies used different accounting methods, a change in accounting method to conform the accounting of the companies should be applied retroactively and financial statements presented for prior periods should be restated.
- 7 Treasury stock issued in a pooling of interests should first be retired.
- 8 Stock of one combining company held by another combining company:
 - a An investment in the common stock of the surviving entity is returned to the surviving company in the combination and becomes treasury stock of the combined entity.
 - b The surviving company's investment in the stock of another combining company is treated as stock retired as part of the combination.
- 9 Operations are reported as if the pooling occurred at the beginning of the period (or the beginning of the earliest period presented).
- 10 Expenses of combining are expenses of the pooled entity.

C Disclosures to be made in the financial statement notes for a pooling of interests:

- 1 A statement that the business combination was a pooling.
- 2 The names of the combined companies.

- 3 A description of the shares issued.
- 4 Details of the results of operations of the separate companies prior to the pooling.
- 5 Nature of any asset adjustments to adopt the same accounting practices and the effect on retained earnings of changing the fiscal period of a combining company.
- 6 Reconciliation of the issuing company's revenue and earnings with combined amounts after the pooling.
- 7 Restatement of prior period financial statements if amounts are material.

Description of assignment material

Minutes

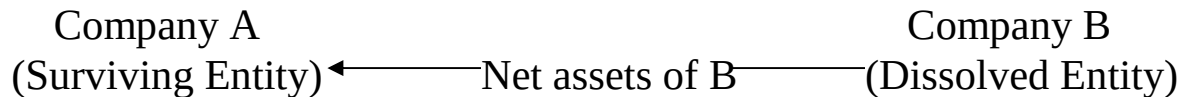
Questions (7)

Problems (17)

W-8	5 MC general	5
W-9	7 MC general	10
W-10	[Pappy/Snippy] Determine exchange ratio and compute shares assumed to be exchanged for a pooling	15
W-11	[Baloney/Nayle] Compute number of shares assumed exchanged for pooling	10
W-12	AICPA 2 MC problem-type	10
W-13	[Carrier/Homer] 2 MC problem-type (expenses of combination)	10
W-14	[Franklin/Harlow] 2 MC general (income after combination)	3
W-15	[Patter/Simpson] 3 MC problem-type (combining assets and equities)	15
W-16	[Ice Age/Jester] Journal entries (recording business combinations)	20
W-17	[Placate/Service] Journal entries (recording a pooling)	10
W-18	[Blair/Tuby] Prepare stockholders' equity section (treasury stock issued in a pooling)	12
W-19	[Tansv/Vatters] Prepare balance sheets of pooled companies	20
W-20	[Gladfresh/Farmstone] Journal entries for recording pooling business combinations	25
W-21	[Quatro/Tertio] Calculate shares assumed and required to be exchanged in a pooling and the journal entry to record the pooling (combining company has treasury stock)	20
W-22	[Dual/Cowhill] Journal entries and balance sheet for a pooling of interests	30
W-23	[Patio/EPA/Century] Journal entries and balance sheet for a consolidation under the pooling of interests method	25
W-24	[Ainsley/Biker] Comparative balance sheets under the pooling and purchase methods	25

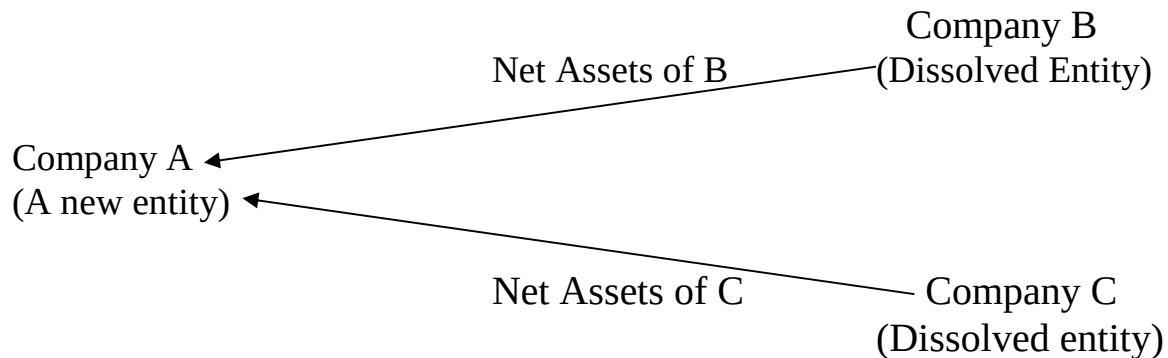
DIAGRAM OF BASIC TYPES OF BUSINESS COMBINATIONS

MERGER



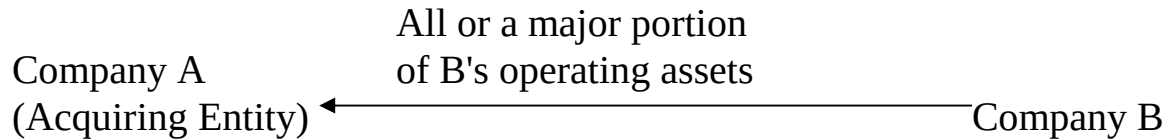
Company A may acquire the net assets of Company B by issuing debt or equity securities or assets directly to Company B for B's net assets or to B's stockholders for all of B's outstanding stock. In either case, Company B is dissolved and Company A takes over the net assets of Company B.

CONSOLIDATION



Company A may acquire the net assets of Company B and Company C by issuing stock directly to Companies B and C for their net assets or to the stockholders of Companies B and C for all of their stock. In either case, Companies B and C are dissolved and Company A takes over their assets.

ACQUISITION OF NET ASSETS WITHOUT DISSOLUTION



Same as for a merger or consolidation except that Company A issues debt or equity securities or assets directly to Company B and Company B continues to exist as a separate legal entity.

ACQUISITION OF OUTSTANDING STOCK

(Parent-Subsidiary operations and consolidated financial statements)



Similar to a merger or consolidation except that Company A receives a majority or the outstanding voting stock of Company B by issuing debt or equity securities or assets to the stockholders of Company B. Company B continues to exist as a separate legal entity and to operate in a parent subsidiary relationship with Company A.