

Package Title: Test Bank Questions
Course Title: Advanced Accounting, 6e
Chapter Number: 1

Question Type: Multiple Choice

1) Stock given as consideration for a business combination is valued at:

- a) fair market value
- b) par value
- c) historical cost
- d) None of these

Answer: a

Question Title: Test Bank (Multiple Choice) Question 01

Difficulty: Medium

Learning Objective: 6 Indicate the factors used to determine the price and the method of payment for a business combination.

Section Reference: 1.8

2) Which of the following situations best describes a business combination to be accounted for as a statutory merger?

- a) Both companies in a combination continue to operate as separate, but related, legal entities.
- b) Only one of the combining companies survives and the other loses its separate identity.
- c) Two companies combine to form a new third company, and the original two companies are dissolved.
- d) One company transfers assets to another company it has created.

Answer: b

Question Title: Test Bank (Multiple Choice) Question 02

Difficulty: Easy

Learning Objective: 5 Distinguish between an asset and a stock acquisition.

Section Reference: 1.5

3) A firm can use which method of financing for an acquisition structured as either an asset or stock acquisition?

- a) Cash
- b) Issuing Debt
- c) Issuing Stock
- d) All of these

Answer: d

Question Title: Test Bank (Multiple Choice) Question 03

Difficulty: Easy

Learning Objective: 6 Indicate the factors used to determine the price and the method of payment for a business combination.

Section Reference: 1.5

4) The objectives of FASB 141R (Business Combinations) and FASB 160 (Noncontrolling Interests in Consolidated Financial Statements) are as follows:

- a) to improve the relevance, comparability, and transparency of financial information related to business combinations.
- b) to eliminate the amortization of Goodwill.
- c) to facilitate the convergence project of the FASB and the International Accounting Standards Board.
- d) to improve the relevance, comparability, and transparency of financial information related to business combinations and to eliminate the amortization of Goodwill.

Answer: d

Question Title: Test Bank (Multiple Choice) Question 04

Difficulty: Medium

Learning Objective: 9 Discuss the Statements of Financial Accounting Concepts (SFAC).

Section Reference: 1.1

5) A business combination in which the boards of directors of the potential combining companies negotiate mutually agreeable terms is a(n):

- a) agreeable combination.
- b) friendly combination.
- c) hostile combination.
- d) unfriendly combination.

Answer: b

Question Title: Test Bank (Multiple Choice) Question 05

Difficulty: Easy

Learning Objective: 4 Identify defensive tactics used to attempt to block business combinations.

Section Reference: 1.2

6) A merger between a supplier and a customer is a(n):

- a) friendly combination.
- b) horizontal combination.
- c) unfriendly combination.
- d) vertical combination.

Answer: d

Question Title: Test Bank (Multiple Choice) Question 06

Difficulty: Easy

Learning Objective: 2 Identify the major reasons firms combine.
Section Reference: 1.3

7) The impairment standard as it relates to goodwill is an example of a:

- a) consumption of benefit approach.
- b) loss or lack of benefit approach.
- c) component of other comprehensive income.
- d) direct matching of expenses to revenues.

Answer: b

Question Title: Test Bank (Multiple Choice) Question 07

Difficulty: Easy

Learning Objective: 9 Discuss the Statements of Financial Accounting Concepts (SFAC).

Section Reference: 1.11

8) The defense tactic that involves purchasing shares held by the would-be acquiring company at a price substantially in excess of their fair value is called:

- a) poison pill.
- b) pac-man defense.
- c) greenmail.
- d) white knight.

Answer: c

Question Title: Test Bank (Multiple Choice) Question 08

Difficulty: Medium

Learning Objective: 4 Identify defensive tactics used to attempt to block business combinations.

Section Reference: 1.2

9) The third period of business combinations started after World War II and is called:

- a) horizontal integration.
- b) merger mania.
- c) operating integration.
- d) vertical integration.

Answer: b

Question Title: Test Bank (Multiple Choice) Question 09

Difficulty: Easy

Learning Objective: 1 Describe historical trends in types of business combinations.

Section Reference: 1.4

10) Which of the following is not a component of other comprehensive income under GAAP?

- a) earnings.
- b) gains and losses that bypass earnings.
- c) impairment losses.
- d) accumulated other comprehensive income.

Answer: d

Question Title: Test Bank (Multiple Choice) Question 10

Difficulty: Easy

Learning Objective: 9 Discuss the Statements of Financial Accounting Concepts (SFAC).

Section Reference: 1.10

11) When a new corporation is formed to acquire two or more other corporations and the acquired corporations cease to exist as separate legal entities, the result is a statutory:

- a) acquisition.
- b) combination.
- c) consolidation.
- d) merger.

Answer: c

Question Title: Test Bank (Multiple Choice) Question 11

Difficulty: Easy

Learning Objective: 5 Distinguish between an asset and a stock acquisition.

Section Reference: 1.5

12) The excess of the amount offered in an acquisition over the prior stock price of the acquired firm is the:

- a) bonus.
- b) goodwill.
- c) implied offering price.
- d) takeover premium.

Answer: d

Question Title: Test Bank (Multiple Choice) Question 12

Difficulty: Easy

Learning Objective: 6 Indicate the factors used to determine the price and the method of payment for a business combination.

Section Reference: 1.6

13) The difference between normal earnings and expected future earnings is:

- a) average earnings.
- b) excess earnings.

- c) ordinary earnings.
- d) target earnings.

Answer: b

Question Title: Test Bank (Multiple Choice) Question 13

Difficulty: Easy

Learning Objective: 7 Calculate an estimate of the value of goodwill to be included in an offering price by discounting expected future excess earnings over some period of years.

Section Reference: 1.8

14) The first step in estimating goodwill in the excess earnings approach is to:

- a) determine normal earnings.
- b) identify a normal rate of return for similar firms.
- c) compute excess earnings.
- d) estimate expected future earnings.

Answer: b

Question Title: Test Bank (Multiple Choice) Question 14

Difficulty: Medium

Learning Objective: 7 Calculate an estimate of the value of goodwill to be included in an offering price by discounting expected future excess earnings over some period of years.

Section Reference: 1.8

15) Many of FASB's recent pronouncements indicate a shift away from historical cost accounting toward:

- a) an elevated status for the Statements of Financial Accounting Concepts.
- b) convergence of standards.
- c) fair value accounting.
- d) representationally faithful reporting.

Answer: c

Question Title: Test Bank (Multiple Choice) Question 15

Difficulty: Medium

Learning Objective: 9 Discuss the Statements of Financial Accounting Concepts (SFAC).

Section Reference: 1.10

16) Estimated goodwill is determined by computing the present value of the:

- a) average earnings.
- b) excess earnings.
- c) expected future earnings.
- d) normal earnings.

Answer: b

Question Title: Test Bank (Multiple Choice) Question 16

Difficulty: Easy

Learning Objective: 7 Calculate an estimate of the value of goodwill to be included in an offering price by discounting expected future excess earnings over some period of years.

Section Reference: 1.8

17) Which of the following statements would not be a valid or logical reason for entering into a business combination?

- a) to increase market share.
- b) to avoid becoming a takeover target.
- c) to reduce risk by acquiring established product lines.
- d) the operating costs of the combined entity would be more than the sum of the separate entities.

Answer: d

Question Title: Test Bank (Multiple Choice) Question 17

Difficulty: Easy

Learning Objective: 2 Identify the major reasons firms combine.

Section Reference: 1.3

18) The parent company concept of consolidation represents the view that the primary purpose of consolidated financial statements is:

- a) to provide information relevant to the controlling stockholders.
- b) to represent the view that the affiliated companies are a separate, identifiable economic entity.
- c) to emphasize control of the whole by a single management.
- d) to include only a portion of the subsidiary's assets, liabilities, revenues, expenses, gains, and losses.

Answer: a

Question Title: Test Bank (Multiple Choice) Question 18

Difficulty: Medium

Learning Objective: 8 Describe the two alternative views of consolidated financial statements: the economic entity and the parent company concepts.

Section Reference: 1.9

Section Reference: 1.9

19) Which of the following statements is correct?

- a) Total elimination is consistent with the parent company concept.
- b) Partial elimination is consistent with the economic unit concept.
- c) Past accounting standards required the total elimination of unrealized intercompany profit in assets acquired from affiliated companies.

d) none of these.

Answer: c

Question Title: Test Bank (Multiple Choice) Question 19

Difficulty: Hard

Learning Objective: 8 Describe the two alternative views of consolidated financial statements: the economic entity and the parent company concepts.

Section Reference: 1.9

Section Reference: 1.9

20) Under the parent company concept, consolidated net income _____ the consolidated net income under the economic unit concept.

- a) is the same as
- b) is higher than
- c) is lower than
- d) can be higher or lower than

Answer: a

Question Title: Test Bank (Multiple Choice) Question 20

Difficulty: Medium

Learning Objective: 8 Describe the two alternative views of consolidated financial statements: the economic entity and the parent company concepts.

Section Reference: 1.9

Section Reference: 1.9

21) Under the economic unit concept, noncontrolling interest in net assets is treated as:

- a) a liability.
- b) an asset.
- c) stockholders' equity.
- d) an expense.

Answer: c

Question Title: Test Bank (Multiple Choice) Question 21

Difficulty: Easy

Learning Objective: 8 Describe the two alternative views of consolidated financial statements: the economic entity and the parent company concepts.

Section Reference: 1.9

Section Reference: 1.9

22) The parent company concept adjusts subsidiary net asset values for the:

- a) differences between cost and fair value.
- b) differences between cost and book value.
- c) total fair value implied by the price paid by the parent.
- d) total cost implied by the price paid by the parent.

Answer: b

Question Title: Test Bank (Multiple Choice) Question 22

Difficulty: Hard

Learning Objective: 8 Describe the two alternative views of consolidated financial statements: the economic entity and the parent company concepts.

Section Reference: 1.9

Section Reference: 1.9

23) According to the economic unit concept, the primary purpose of consolidated financial statements is to provide information that is relevant to:

- a) majority stockholders.
- b) minority stockholders.
- c) creditors.
- d) both majority and minority stockholders.

Answer: d

Question Title: Test Bank (Multiple Choice) Question 23

Difficulty: Easy

Learning Objective: 8 Describe the two alternative views of consolidated financial statements: the economic entity and the parent company concepts.

Section Reference: 1.9

Section Reference: 1.9

24) Which of the following statements is correct?

- a) The economic unit concept suggests partial elimination of unrealized intercompany profits.
- b) The parent company concept suggests partial elimination of unrealized intercompany profits.
- c) The economic unit concept suggests no elimination of unrealized intercompany profits.
- d) The parent company concept suggests total elimination of unrealized intercompany profits.

Answer: b

Question Title: Test Bank (Multiple Choice) Question 24

Difficulty: Easy

Learning Objective: 8 Describe the two alternative views of consolidated financial statements: the economic entity and the parent company concepts.

Section Reference: 1.9

Section Reference: 1.9

25) When following the parent company concept in the preparation of consolidated financial statements, noncontrolling interest in combined income is considered a(n):

- a) prorated share of the combined income.
- b) addition to combined income to arrive at consolidated net income.
- c) expense deducted from combined income to arrive at consolidated net income.
- d) deduction from current assets in the balance sheet.

Answer: c

Question Title: Test Bank (Multiple Choice) Question 25

Difficulty: Medium

Learning Objective: 8 Describe the two alternative views of consolidated financial statements: the economic entity and the parent company concepts.

Section Reference: 1.9

Section Reference: 1.9

26) When following the economic unit concept in the preparation of consolidated financial statements, the basis for valuing the noncontrolling interest in net assets is the:

- a) book values of subsidiary assets and liabilities.
- b) fair values of subsidiary assets and liabilities.
- c) general price level adjusted values of subsidiary assets and liabilities.
- d) fair values of parent company assets and liabilities.

Answer: b

Question Title: Test Bank (Multiple Choice) Question 26

Difficulty: Easy

Learning Objective: 8 Describe the two alternative views of consolidated financial statements: the economic entity and the parent company concepts.

Section Reference: 1.9

Section Reference: 1.9

27) The view that consolidated financial statements represent those of a single economic entity with several classes of stockholder interest is consistent with the:

- a) parent company concept.
- b) current practice concept.
- c) historical cost company concept.
- d) economic unit concept.

Answer: d

Question Title: Test Bank (Multiple Choice) Question 27

Difficulty: Easy

Learning Objective: 8 Describe the two alternative views of consolidated financial statements: the economic entity and the parent company concepts.

Section Reference: 1.9

Section Reference: 1.9

28) The view that the noncontrolling interest in income reflects the noncontrolling stockholders' allocated share of consolidated income is consistent with the:

- a) economic unit concept.
- b) parent company concept.
- c) current practice concept.
- d) historical cost company concept.

Answer: a

Question Title: Test Bank (Multiple Choice) Question 28

Difficulty: Easy

Learning Objective: 8 Describe the two alternative views of consolidated financial statements: the economic entity and the parent company concepts.

Section Reference: 1.9

Section Reference: 1.9

29) The view that only the parent company's share of the unrealized intercompany profit recognized by the selling affiliate that remains in assets should be eliminated in the preparation of consolidated financial statements is consistent with the:

- a) economic unit concept.
- b) current practice concept.
- c) parent company concept.
- d) historical cost company concept.

Answer: c

Question Title: Test Bank (Multiple Choice) Question 29

Difficulty: Medium

Learning Objective: 8 Describe the two alternative views of consolidated financial statements: the economic entity and the parent company concepts.

Section Reference: 1.9

Section Reference: 1.9

Question Type: Essay

30) Estimating the value of goodwill to be included in an offering price can be done under several alternative methods. The excess earnings approach is frequently used. Identify the steps used in this approach to estimate goodwill.

Answer: The excess earnings approach to estimating goodwill includes the following steps: (a) Identify a normal rate of return for firms similar to the company being targeted, (b) Apply the identified rate of return of the level of identifiable assets (or net assets) of the target to approximate what would be normal earnings in this industry, (c) Estimate the expected future earnings of the target, (d) Subtract the normal earnings from the expected target earnings to compute “excess earnings”, and (e) Assume an appropriate time period and a discount rate to compute the discounted value of the excess earnings – the estimated goodwill.

Question Title: Test Bank (Essay) Question 01

Difficulty: Medium

Learning Objective: 7 Calculate an estimate of the value of goodwill to be included in an offering price by discounting expected future excess earnings over some period of years.

Section Reference: 1.8

31) The two alternative views of consolidated financial statements are the parent company concept and the economic entity concept. Briefly explain the differences between the concepts.

Answer: Under the parent company concept, the consolidated financial statements reflect the stockholders' interests in the parent, plus their undivided interests in the net assets of the parent's subsidiaries. The focus is on the interests of the parent's shareholders.

Under the economic entity concept, control of the whole by a single management is emphasized. With this concept, consolidated financial statements are intended to provide information about a group of legal entities – a parent company and its subsidiaries – operating as a single unit.

Question Title: Test Bank (Essay) Question 02

Difficulty: Easy

Learning Objective: 8 Describe the two alternative views of consolidated financial statements: the economic entity and the parent company concepts.

Section Reference: 1.9

Section Reference: 1.9

32) Hopkins Company is considering the acquisition of Richfield, Inc. To assess the amount it might be willing to pay, Hopkins makes the following computations and assumptions.

A. Richfield, Inc. has identifiable assets with a total fair value of \$6,000,000 and liabilities of \$3,700,000. The assets include office equipment with a fair value approximating book value, buildings with a fair value 25% higher than book value, and land with a fair value 50% higher than book value. The remaining lives of the assets are deemed to be approximately equal to those used by Richfield, Inc.

B. Richfield, Inc.'s pretax incomes for the years 2014 through 2016 were \$470,000, \$570,000, and \$370,000, respectively. Hopkins believes that an average of these earnings represents a fair estimate of annual earnings for the indefinite future. However, it may need to consider adjustments for the following items included in pretax earnings:

Depreciation on Buildings (each year)	380,000
Depreciation on Equipment (each year)	30,000
Extraordinary Loss (year 2016)	130,000

Salary Expense (each year)	170,000
----------------------------	---------

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

Required:

A. Assume that Hopkins feels that it must earn a 20% return on its investment, and that goodwill is determined by capitalizing excess earnings. Based on these assumptions, calculate a reasonable offering price for Richfield, Inc. Indicate how much of the price consists of goodwill.

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

Answer:

A. Normal earnings for similar firms = $(\$6,000,000 - \$3,700,000) \times 15\% = \$345,000$

Expected earnings of target:

Pretax income of Richfield, Inc., 2014	\$470,000	
Subtract: Additional depreciation on buildings $(\$380,000 \times .25)$	<u>(95,000)</u>	
Target's adjusted earnings, 2014		375,000
 Pretax income of Richfield, Inc., 2015	 \$570,000	
Subtract: Additional depreciation on buildings	<u>(95,000)</u>	
Target's adjusted earnings, 2015		475,000
 Pretax income of Richfield, Inc., 2016	 \$370,000	
Add: Extraordinary loss	130,000	
Subtract: Additional depreciation on buildings	<u>(95,000)</u>	
Target's adjusted earnings, 2016		405,000
 Target's three year total adjusted earnings		1,255,000
Target's three year average adjusted earnings		418,333

Excess earnings of target = $\$418,333 - \$345,000 = \$73,333$ per year

Present value of excess earnings (perpetuity) at 20%: $\frac{\$73,333}{20\%} = \$366,665$ (Estimated Goodwill)

Implied offering price = $\$6,000,000 - \$3,700,000 + \$366,665 = 2,666,665$.

B. Excess earnings of target (same as in A): \$73,333

Present value of excess earnings (ordinary annuity) for five years at 15%; $\$73,333 \times 3.35216 = \$245,824$

Implied offering price = $\$6,000,000 - \$3,700,000 + \$245,824 = \$2,545,824$.

Note: The salary expense and depreciation on equipment are expected to continue at the same rate, and thus do not necessitate adjustments.

Question Title: Test Bank (Problem) Question 1-1

Difficulty: Hard

Learning Objective: 7 Calculate an estimate of the value of goodwill to be included in an offering price by discounting expected future excess earnings over some period of years.

Section Reference: 1.8

33) Eden Company is trying to decide whether to acquire Bloomington Inc. The following balance sheet for Bloomington Inc. provides information about book values. Estimated market values are also listed, based upon Eden Company's appraisals.

	Bloomington Inc. <u>Book Values</u>	Bloomington Inc. <u>Market Values</u>
Current Assets	\$ 450,000	\$ 450,000
Property, Plant & Equipment (net)	1,140,000	1,300,000
Total Assets	\$1,590,000	\$1,750,000
Total Liabilities	\$700,000	\$700,000
Common Stock, \$10 par value	280,000	
Retained Earnings	610,000	
Total Liabilities and Equities	\$1,590,000	

Eden Company expects that Bloomington will earn approximately \$290,000 per year in net income over the next five years. This income is higher than the 14% annual return on tangible assets considered to be the industry "norm."

Required:

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

- (1) Eden is willing to pay for excess earnings for an expected life of 4 years (undiscounted).
- (2) Eden is willing to pay for excess earnings for an expected life of 4 years, which should be capitalized at the industry normal rate of return.
- (3) Excess earnings are expected to last indefinitely, but Eden demands a higher rate of return of 20% because of the risk involved.

B. Determine the amount of goodwill to be recorded on the books if Eden pays \$1,300,000 cash and assumes Bloomington's liabilities.

Answer:

A. Normal earnings for similar firms (based on tangible assets only) = $\$1,750,000 \times 14\% = \$245,000$

Excess earnings = $\$290,000 - 245,000 = \$45,000$

- (1) Goodwill based on four years excess earnings undiscounted.
Goodwill = $(\$45,000)(4 \text{ years}) = \$180,000$
- (2) Goodwill based on four years discounted excess earnings
Goodwill = $(\$45,000)(2.91371) = \$131,117$
(present value of an annuity factor for $n=4$, $I=14\%$ is 2.91371)
- (3) Goodwill based on a perpetuity
Goodwill = $(\$45,000)/.20 = \$225,000$

- B. Goodwill = Cost less fair value of net assets
 Goodwill = (\$1,300,000 - (\$1,750,000 - \$700,000)) = \$250,000

Question Title: Test Bank (Problem) Question 1-2

Difficulty: Hard

Learning Objective: 7 Calculate an estimate of the value of goodwill to be included in an offering price by discounting expected future excess earnings over some period of years.

Section Reference: 1.8

34) Park Company acquired an 80% interest in the common stock of Southdale Company for \$1,540,000 on July 1, 2016. Southdale Company's stockholders' equity on that date consisted of:

Common stock	\$800,000
Other contributed capital	400,000
Retained earnings	330,000

Required:

Compute the total noncontrolling interest to be reported in the consolidated balance sheet assuming the:

- (1) parent company concept.
- (2) economic unit concept.

Answer:

1.

Total book value of Southdale's net assets (\$800,000 + \$400,000 + \$330,000)	\$1,530,000
Noncontrolling interest %	<u>× .2</u>
Noncontrolling interest in net assets	<u><u>\$306,000</u></u>

2.

Total fair value of Southdale's net assets (\$1,540,000/.8)	\$1,925,000
Noncontrolling interest %	<u>× .2</u>
Noncontrolling interest in net assets	<u><u>\$385,000</u></u>

Question Title: Test Bank (Problem) Question 1-3

Difficulty: Medium

Learning Objective: 8 Describe the two alternative views of consolidated financial statements: the economic entity and the parent company concepts.

Section Reference: 1.9

Section Reference: 1.9

35) The following balances were taken from the records of S Company:

Common stock (1/1/13 and 12/31/13)	\$720,000
------------------------------------	-----------

Retained earnings 1/1/13	\$160,000	
Net income for 2016	180,000	
Dividends declared in 2016	<u>(40,000)</u>	
Retained earnings, 12/31/13		<u>300,000</u>
Total stockholders' equity on 12/31/13		<u>\$1,020,000</u>

P Company purchased 75% of S Company's common stock on January 1, 2014 for \$900,000. The difference between implied value and book value is attributable to assets with a remaining useful life on January 1, 2016 of ten years.

Required:

- A. Compute the difference between cost/(implied) and book value applying:
 1. Parent company theory.
 2. Economic unit theory.
- B. Assuming the economic unit theory:
 1. Compute noncontrolling interest in consolidated income for 2016.
 2. Compute noncontrolling interest in net assets on December 31, 2016.

Answer:

A1. Cost of investment	\$900,000
Equity acquired .75(\$720,000 + \$160,000)	<u>660,000</u>
Difference (parent company theory)	<u>\$240,000</u>
2. Implied value of S Company (\$900,000/.75)	\$1,200,000
Book value of S Company (\$720,000 + \$160,000)	<u>880,000</u>
Difference (economic unit theory)	<u>\$320,000</u>
B1. Noncontrolling interest in consolidated income:	
.25[\$180,000 - (\$320,000/10)]	<u>\$37,000</u>
2. Noncontrolling interest in net assets:	
.25[\$1,020,000 + (9/10 × \$320,000)]	<u>\$327,000</u>

Question Title: Test Bank (Problem) Question 1-4

Difficulty: Hard

Learning Objective: 8 Describe the two alternative views of consolidated financial statements: the economic entity and the parent company concepts.

Section Reference: 1.9