Chapter 1

BUSINESS COMBINATIONS

Answers to Questions

1 A business combination is a union of business entities in which two or more previously separate and independent companies are brought under the control of a single management team. Three situations establish the control necessary for a business combination, namely, when one or more corporations become subsidiaries, when one company transfers its net assets to another, and when each combining company transfers its net assets to a newly formed corporation.

2 The dissolution of all but one of the separate legal entities is *not* necessary for a business combination. An example of one form of business combination in which the separate legal entities are not dissolved is when one corporation becomes a subsidiary of another. In the case of a parent-subsidiary relationship, each combining company continues to exist as a separate legal entity even though both companies are under the control of a single management team.

3 A business combination occurs when two or more previously separate and independent companies are brought under the control of a single management team. Merger and consolidation in a generic sense are frequently used as synonyms for the term *business combination*. In a technical sense, however, a *merger* is a type of business combination in which all but one of the combining entities are dissolved and a *consolidation* is a type of business combination in which a new corporation is formed to take over the assets of two or more previously separate companies and all of the combining companies are dissolved.

4 Goodwill arises in a business combination accounted for under the acquisition method when the cost of the investment (fair value of the consideration transferred) exceeds the fair value of identifiable net assets acquired. Under GAAP, goodwill is not amortized for financial reporting purposes and will have no effect on net income, unless the goodwill is deemed to be impaired. If goodwill is impaired, a loss will be recognized.

5 A bargain purchase occurs when the acquisition price is less than the fair value of the identifiable net assets acquired. The acquirer records the gain from a bargain purchase as an ordinary gain during the period of the acquisition. The gain equals the difference between the investment cost and the fair value of the identifiable net assets acquired.

SOLUTIONS TO EXERCISES

Solution E1-1

1 b
2 c
3 c
4 c

Solution E1-2 [AICPA adapted]

1 **a**
Plant and equipment should be recorded at the $220,000 fair value.

2 c

Investment cost		$1,600,000
Less: Fair value of net assets		
Cash	$ 160,000	
Inventory	380,000	
Property and equipment — net	1,120,000	
Liabilities	(360,000)	1,300,000
Goodwill		$ 300,000

Solution E1-3

Stockholders' equity — Pop Corporation on January 3

Capital stock, $10 par, 600,000 shares outstanding	$ 6,000,000
Other paid-in capital [$400,000 + $3,000,000 – $10,000]	3,390,000
Retained earnings [$1,200,000 - $20,000]	1,180,000
Total stockholders' equity	$10,570,000

Entry to record combination

Investment in Son	6,000,000	
Capital stock, $10 par		3,000,000
Other paid-in capital		3,000,000
Investment expense	20,000	
Other paid-in capital	10,000	
Cash		30,000

Check: Net assets per books (book value)	$ 7,600,000
Goodwill and write-up of assets	3,000,000
Less: Expense of direct costs	(20,000)
Less: Issuance of stock	(10,000)
	$10,570,000

Solution E1-4

Journal entries on Pam's books to record the acquisition

Investment in Sun	10,200,000	
Common stock, $10 par		4,800,000
Additional paid-in capital		5,400,000

To record issuance of 480,000 shares of $10 par common stock with a fair value of $10,200,000 for the common stock of Sun in a business combination.

Additional paid-in capital	60,000	
Investment expenses	180,000	
Other assets (or Cash)		240,000

To record costs of registering and issuing securities as a reduction of paid-in capital, and record direct and indirect costs of combination as expenses.

Current assets	4,400,000	
Plant assets	8,800,000	
Liabilities		1,200,000
Investment in Sun		10,200,000
Gain from bargain purchase		1,800,000

To record allocation of the $10,200,000 cost of Sun Company to identifiable assets and liabilities according to their fair values, and the gain from the bargain purchase,computed as follows:

Cost	$10,200,000
Fair value of net assets acquired	12,000,000
Bargain purchase amount	$ 1,800,000

Solution E1-5

Journal entries on the books of Pop Corporation to record merger with Son Corporation

Investment in Son	1,060,000	
Common stock, $10 par		360,000
Additional paid-in capital		300,000
Cash		400,000
To record issuance of 36,000 common shares and payment of cash in the acquisition of Son Corporation in a merger.		
Investment expenses	140,000	
Additional paid-in capital	60,000	
Cash		200,000
To record costs of registering and issuing securities and additional direct costs of combination.		
Cash	80,000	
Inventories	200,000	
Other current assets	40,000	
Plant assets — net	560,000	
Goodwill	320,000	
Current liabilities		60,000
Other liabilities		80,000
Investment in Son		1,060,000
To record allocation of cost to assets received and liabilities assumed on the basis of their fair values and to goodwill computed as follows:		

Cost of investment	$1,060,000
Fair value of net assets acquired	740,000
Goodwill	$ 320,000

Solution E1-6*

Net assets (+A)	2,200	
Common stock (+SE)		1,200
Additional paid-in capital (+SE)		800
Retained earnings (+SE)		200
Expenses (E, -SE)	60	
Cash (-A)		60

Solution E1-7*

Net assets (+A)	2,100	
Capital stock (+SE)		1,470
Retained earnings (+SE)		600
Investment in Sun Corporation (-A)		30

SOLUTIONS TO PROBLEMS

Solution P1-1
(in thousands)

Preliminary computations

Fair Value: Cost of investment in Son at January 2 (240,000 shares × $40)	$9,600
Book value of net assets ($8,000 - $960)	(7,040)
Excess fair value over book value	$2,560

Excess assigned to:	
Current assets	$ 640
Remainder to goodwill	1,920
Excess fair value over book value	$2,560

Note: $400,000 direct costs of combination are expensed. The excess fair value of Pop's buildings is not considered.

Pop Corporation
Balance Sheet at January 2, 2016
(in thousands)

Assets

Current assets ($2,080 + $960 + $640 excess - $640 direct costs)	$ 3,040
Land ($800 + $1,600)	2,400
Buildings — net ($4,800 + $1,600)	6,400
Equipment — net ($3,520 + $3,840)	7,360
Goodwill	1,920
Total assets	$21,120

Liabilities and Stockholders' Equity

Current liabilities ($800 + $960)	$ 1,760
Capital stock, $10 par ($8,000 + $2,400 new issue)	10,400
Additional paid-in capital [$800 + ($30 × 240 shares) — $240 costs of issuing and registering securities]	7,760
Retained earnings (subtract $400 expensed direct cost)	1,200
Total liabilities and stockholders' equity	$ 21,120

Solution P1-2

Preliminary computations

Fair Value: Cost of acquiring Son	$1,650,000
Fair value of assets acquired and liabilities assumed	1,340,000
Goodwill from acquisition of Son	$ 310,000

Pop Corporation
Balance Sheet
at January 2, 2016

Assets	
Current assets	
Cash [$300,000 + $60,000 - $280,000 expenses paid]	$ 80,000
Accounts receivable—net [$460,000 + $80,000 fair value]	540,000
Inventories [$1,040,000 + $240,000 fair value]	1,280,000
Plant assets	
Land [$800,000 + $300,000 fair value]	1,100,000
Buildings—net [$2,000,000 + $600,000 fair value]	2,600,000
Equipment—net [$1,000,000 + $500,000 fair value]	1,500,000
Goodwill	310,000
Total assets	$7,410,000
Liabilities and Stockholders' Equity	
Liabilities	
Accounts payable [$600,000 + $80,000]	$ 680,000
Note payable [$1,200,000 + $360,000 fair value]	1,560,000
Stockholders' equity	
Capital stock, $10 par [$1,600,000 + (66,000 shares × $10)]	2,260,000
Other paid-in capital [$1,200,000 - $80,000 + ($1,650,000 - $660,000)]	2,110,000
Retained earnings (subtract $200,000 expensed direct costs)	800,000
Total liabilities and stockholders' equity	$7,410,000

Solution P1-3

Pam issues 25,000 shares of stock for Sun's outstanding shares

1a

Investment in Sun	1,500,000	
Capital stock, $10 par		250,000
Additional paid-in capital		1,250,000
To record issuance of 25,000, $10 par shares with a market price of $60 per share in a business combination with Sun.		
Investment expenses	60,000	
Additional paid-in capital	40,000	
Cash		100,000
To record costs of combination in a business combination with Sun.		
Cash	20,000	
Inventories	120,000	
Other current assets	200,000	
Land	200,000	
Plant and equipment — net	700,000	
Goodwill	360,000	
Liabilities		100,000
Investment in Sun		1,500,000

To assign investment cost to identifiable assets and liabilities according to their fair values and the remainder to goodwill. Goodwill is computed: $1,500,000 cost - $1,140,000 fair value of net assets acquired.

1b

Pam Corporation
Balance Sheet
January 2, 2016
(after business combination)

Assets	
Cash [$240,000 + $20,000 - $100,000]	$ 160,000
Inventories [$100,000 + $120,000]	220,000
Other current assets [$200,000 + $200,000]	400,000
Land [$160,000 + $200,000]	360,000
Plant and equipment — net [$1,300,000 + $700,000]	2,000,000
Goodwill	360,000
Total assets	$3,500,000
Liabilities and Stockholders' Equity	
Liabilities [$400,000 + $100,000]	$ 500,000
Capital stock, $10 par [$1,000,000 + $250,000]	1,250,000
Additional paid-in capital [$400,000 + $1,250,000 - $40,000]	1,610,000
Retained earnings (subtract $60,000 direct costs)	140,000
Total liabilities and stockholders' equity	$3,500,000

Solution P1-3 (continued)

Pam issues 15,000 shares of stock for Sun's outstanding shares

2a

Investment in Sun (15,000 shares × $60)	900,000	
Capital stock, $10 par		150,000
Additional paid-in capital		750,000
To record issuance of 15,000, $10 par common shares with a market price of $60 per share.		
Investment expense	60,000	
Additional paid-in capital	40,000	
Cash		100,000
To record costs of combination in the acquisition of Sun.		
Cash	20,000	
Inventories	120,000	
Other current assets	200,000	
Land	200,000	
Plant and equipment — net	700,000	
Liabilities		100,000
Investment in Sun		900,000
Gain on bargain purchase		240,000
To record Sun's net assets at fair values and the gain on the bargain purchase.		

Fair value of net assets acquired	$1,140,000
Investment cost (Fair value of consideration)	900,000
Gain on Bargain Purchase	$ 240,000

2b

Pam Corporation
Balance Sheet
January 2, 2016
(after business combination)

Assets	
Cash [$240,000 + $20,000 - $100,000]	$ 160,000
Inventories [$100,000 + $120,000]	220,000
Other current assets [$200,000 + $200,000]	400,000
Land [$160,000 + $200,000]	360,000
Plant and equipment — net [$1,300,000 + $700,000]	2,000,000
Total assets	$3,140,000
Liabilities and stockholders' equity	
Liabilities [$400,000 + $100,000]	$ 500,000
Capital stock, $10 par [$1,000,000 + $150,000]	1,150,000
Additional paid-in capital [$400,000 + $750,000 - $40,000]	1,110,000
Retained earnings (subtract $60,000 direct costs and add $240,000 Gain from bargain purchase)	380,000
Total liabilities and stockholders' equity	$3,140,000

Solution P1-4

1 *Schedule to allocate investment cost to assets and liabilities*

Investment cost (fair value), January 1	$250,000
Fair value acquired from Diego ($300,000 × 100%)	300,000
Excess fair value over cost (bargain purchase gain)	$ 50,000

Allocation:

	Allocation
Cash	$ 40,000
Receivables — net	30,000
Inventories	100,000
Land	50,000
Buildings — net	100,000
Equipment — net	75,000
Accounts payable	(50,000)
Other liabilities	(45,000)
Gain on bargain purchase	(50,000)
Totals	$ 250,000

2

Pablo Corporation
Balance Sheet
at January 1, 2017
(after combination)

Assets		*Liabilities*	
Cash	$ 90,000	Accounts payable	$ 130,000
Receivables — net	80,000	Note payable (5 years)	200,000
Inventories	230,000	Other liabilities	145,000
Land	100,000	Liabilities	475,000
Buildings — net	250,000		
Equipment — net	175,000	*Stockholders' Equity*	
		Capital stock, $10 par	200,000
		Other paid-in capital	100,000
		Retained earnings*	150,000
		Stockholders' equity	450,000
Total assets	$ 925,000	Total equities	$ 925,000

* Retained earnings reflects the $50,000 gain on the bargain purchase.

Solution P1-5

1 *Journal entries to record the acquisition of Huang Corporation*

Investment in Huang	350,000	
Common stock, $10 par		100,000
Other paid-in capital		200,000
Cash		50,000

To record acquisition of Huang for 10,000 shares of common stock and $50,000 cash

Investment expense	30,000	
Other paid-in capital	10,000	
Cash		40,000

To record payment of costs to register and issue the shares of stock ($10,000) and for accounting and legal fees ($30,000).

Cash	50,000	
Receivables—net	50,000	
Inventories	100,000	
Land	100,000	
Buildings—net	100,000	
Equipments—net	100,000	
Accounts payable		50,000
Other liabilities		75,000
Investment in Huang		350,000
Gain on bargain purchase		25,000

To record the net assets of Saw at fair value and the gain on the bargain purchase.

Gain on Bargain Purchase Calculation

Acquisition price	$ 350,000
Fair value of net assets acquired	375,000
Gain on bargain purchase	$ 25,000

Balance Sheet:

Ling Corporation
Balance Sheet
at January 1, 2017

Assets	$	*Liabilities*	$
Cash	960,000	Accounts payable	$ 850,000
Receivable—net	800,000	Other liabilities	1,075,000
Inventories	1,600,000	Liabilities	1,925,000
Land	1,100,000		
Buildings—net	2,100,000		
Equipment—net	1,600,000	Stockholders' equity	
		Common stock, $10 par	3,100,000
		Other paid-in capital	1,390,000
		Retained earnings*	1,745,000
		Stockholders' equity	6,235,000
Total assets	$ 8,160,000	Total equities	$ 8,160,000

Solution P1-5 (continued)

2 *Journal entries to record the acquisition of Huang Corporation:*

Investment in Huang	400,000	
Common Stock, $10 par		100,000
Other paid-in capital		200,000
Cash		100,000
To record acquisition of Huang for 10,000 shares of common stock and $50,000 cash.		
Investment expense	30,000	
Other paid-in capital	10,000	
Cash		40,000
To record payment of costs to register and issue the shares of stock ($10,000) and for accounting and legal fees ($30,000).		
Cash	50,000	
Receivables—net	50,000	
Inventories	100,000	
Land	100,000	
Buildings—net	100,000	
Equipments—net	100,000	
Goodwill	25,000	
Accounts payable		50,000
Other liabilities		75,000
Investment in Huang		400,000
To record the net assets of Saw at fair value and the goodwill.		
Goodwill calculation		
Acquisition price		$400,000
Fair value of net assets acquired		375,000
Goodwill		$ 25,000

Balance Sheet:

Ling Corporation
Balance Sheet
at January 1, 2017

Assets		*Liabilities*	
Cash	$ 910,000	Accounts Payable	$ 850,000
Receivable—net	800,000	Other Liabilities	1,075,000
Inventories	1,600,000	Liabilities	1,925,000
Land	1,100,000		
Buildings—net	2,100,000		
Equipment—net	1,600,000	Stockholders' Equity	
Goodwill	25,000		
		Common Stock, $10 par	3,100,000
		Other paid-in capital	1,390,000
		Retained Earnings*	1,720,000
		Stockholders' equity	6,210,000
Total assets	$ 8,135,000	Total equities	$ 8,135,000

Solution P1-6*

			Pooled Balance Sheets	
	Pop	**Son**	**800,000 shares**	**1,000,000 shares**
Current assets	15,000	4,000	19,000	19,000
Plant assets - net	40,000	6,000	46,000	46,000
Total assets	55,000	10,000	65,000	65,000
Liabilities	10,000	3,000	13,000	13,000
Common stock	30,000	4,000	38,000	40,000
APIC	3,000	2,000	1,000	0
Retained earnings	12,000	1,000	13,000	12,000
Total equities	55,000	10,000	65,000	65,000

Solution P1-7*

1.

Net assets (+A)	800	
Capital stock (+SE)		350
Additional paid-in capital (+SE)		150
Retained earnings (+SE)		300

2.

Net assets (+A)	800	
Additional paid-in capital (-SE)	200	
Capital stock (+SE)		770
Retained earnings (+SE)		230

Solution P1-8*

a.

Net assets (+A)	11,500	
Treasury stock (-SE)	500	
Common stock (+SE)		10,000
Additional paid-in capital (+SE)		1,000
Retained earnings (+SE)		1,000
Investment expenses (E, -SE)	300	
Cash(-A)		300

b.

	Pop Corporation	Son Corporation	Merger Pop's Books
Current Assets	$6,500	$4,500	$10,700
Plant & Equipment--net	10,000	10,000	20,000
Investment in Pop		500	
Total Assets	$16,500	$15,000	$30,700
Liabilities	$1,500	$3,000	$4,500
Common Stock	10,000	8,000	20,000
Add. Paid-in Capital	2,000	3,000	3,000
Retained Earnings	3,000	1,000	3,700
Treasury Stock			(500)
Total Equities	$16,500	$15,000	$30,700

*Current assets and retained earnings are reduced $300 for investment expenses.

Solution PR 1-1 (ASC 350-20-50) GAAP requires the following information for each balance sheet presented:

The change in the carrying amount of goodwill during the period.

a. The gross amount and accumulated impairment losses at the beginning of the period

b. Additional goodwill recognized during the period, except goodwill included in a disposal group that, on acquisition, meets the criteria to be classified as held for sale

c. Adjustments resulting from the subsequent recognition of deferred tax assets during the period

d. Goodwill included in a disposal group classified as held for sale
e. Impairment losses recognized during the period in accordance with this Subtopic

f. Net exchange differences arising during the period

g. Any other changes in the carrying amounts during the period

h. The gross amount and accumulated impairment losses at the end of the period.

Solution PR 1-2 (ASC 805-20-30-12) Yes, there are fair value exceptions. The codification lists those exceptions and provides separate guidance in accounting for these items. Here are the listed exceptions:

a. Income taxes

b. Employee benefits

c. Indemnification assets

d. Reacquired rights

e. Share-based payment awards

f. Assets held for sale

g. Certain assets and liabilities arising from contingencies.