Chapter 1

Intercorporate Acquisitions and Investments in Other Entities

• This chapter provides an overview of complex organizational arrangements (or structures).
• Complex organization structures often result from complex business strategies such as:
  • Extending operations into foreign countries.
  • Initiating new product lines.
  • Separating activities that fall under regulatory controls.
  • Reducing taxes by separating certain types of operations.

• Several accounting transactions may be required to initiate a complex organization structure.
• Additionally, unlike most of your previous accounting courses, you will need to analyze multiple transactions for multiple companies simultaneously—not just one transaction for one company.
• Thus you will need to “deal with” more than one set of books in analyzing questions, cases, exercises, and problems.

Intercorporate Acquisitions and Investments in Other Entities

Did the company acquire the common stock of another company or the assets of another company?
Was the company dissolved (i.e., liquidated) or did the company continue to exist (i.e., survive)?
Was a new company formed?
Was there a change in ownership control?
Is the acquired company wholly-owned?

Creating Business Entities—Basic Transactions

• Complex business structures are routinely grounded in the following basic transactions:
  • Transfer (Sale) of Assets/Entity Dissolved
  • Receipt of Assets from Dissolved Entity
  • Transfer (Sale) of Assets/Entity Survives
  • Receipt of Assets from Surviving entity

NOTE: Assume that Book Values (BV) equal Fair Values (FV) for these transactions (i.e., the next four slides). Also, assume that cash was paid for the assets. The significance of both of these assumptions will be discussed later.

Bad News--Good News

Bad News: Numerous complex organization arrangements are discussed in this chapter. (Hint: Look for similarities in the various complex organization arrangements.)

Good News: The next nine chapters focus on one complex organization arrangement--stock acquisitions.
Transfer of Assets/Entity Dissolved

- Entries Recorded By Seller Company:
  - To transfer net assets to Purchaser Company.
  - Cash (from Purchaser) ???
  - Current Liabilities BV
  - Accumulated Depreciation BV
  - Cash and Receivables BV
  - Inventory BV
  - Fixed Assets BV

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Transfer of Assets/Entity Dissolved

- Entries Recorded By Seller Company:
  - To distribute remaining assets to shareholders of Seller Company.
  - Common Stock BV
  - Additional Paid-In Capital BV
  - Retain Earnings BV
  - Cash ???

Receipt of Assets from Dissolved Entity

- Entry Recorded By Purchaser Company:
  - To record net assets purchased from Seller Company.
  - Cash and Receivables BV
  - Inventory BV
  - Fixed Assets (net) * BV
    - Cash (to Seller) ???
    - Current Liabilities BV
  * Fixed Assets are recorded net of Accumulated Depreciation.

Receipt of Assets from Surviving Entity

- Entry Recorded By Purchaser Company:
  - To record net assets purchased from Seller Company.
    - Cash and Receivables BV
    - Inventory BV
    - Fixed Assets (net) * BV
    - Cash (to Seller) ???
    - Current Liabilities BV
  * Fixed Assets are recorded net of Accumulated Depreciation.

Transfer of Assets/Entity Survives

- Entries Recorded By Seller Company:
  - To transfer net assets to Purchaser Company.
  - Cash (from Purchaser) ???
  - Current Liabilities BV
  - Accumulated Depreciation BV
  - Cash and Receivables BV
  - Inventory BV
  - Fixed Assets BV

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Transfer of Assets/Entity Survives

- Entries Recorded By Seller Company:
  - To distribute remaining assets to shareholders of Seller Company.
    - NO ENTRY REQUIRED—Seller Company was not dissolved. Thus the shareholders of Seller Company may reinvest the Cash (from Purchaser) as they wish.
Receipt of Assets from Surviving Entity

NOTE: Since this was a purchase of the net assets of Seller Company (and not the common stock of Seller Company), dissolution or non-dissolution of Seller Company does not involve Purchaser Company. Thus Purchaser Company records the same entry as was previously done when Seller Company was dissolved.

Additional Thoughts

• Seller Company would have recorded a “GAIN ON SALE” if their net assets would have been sold for an amount greater than book value. In turn, Seller Company would have recorded a “LOSS ON SALE” if their net assets would have been sold for an amount less than book value.

• In either case, Purchaser Company would have recorded the various assets and liabilities at their individual fair value (not book value).

Forms of Business Combinations

• There are three primary forms of business combinations:
  
  • Statutory Merger
  
  • Statutory Consolidation
  
  • Stock Acquisition

Statutory Merger

• A statutory merger occurs when one company acquires another company and the assets and liabilities of the acquired company are transferred to the acquiring company.

• In a statutory merger, the acquired company is liquidated and the acquiring company continues to exist.

Statutory Consolidation

• A statutory consolidation occurs when a new company is formed to acquire the assets and liabilities of two combining company.

• In a statutory consolidation, the combining companies are dissolved and the new company is the only surviving entity.

Stock Acquisition

• A stock acquisition occurs when one company acquires a majority of the common stock of another company and the acquired company is not liquidated.

• In a stock acquisition, both companies continue to operate as separate but related corporations (i.e., affiliated corporations).
Stock Acquisition: Parent-Subsidiary Relationship

• A subsidiary is a corporation that is controlled (through common stock ownership) by another corporation, that is, the parent corporation.
  • Controlling Interest: The parent owns a majority of the common stock of the subsidiary.
  • Wholly-Owned Subsidiary: The parent owns all of the common stock of the subsidiary.
• Given that a subsidiary is a separate legal entity, the parent’s risk associated with the subsidiary’s activities is limited.

Valuation of Business Entities

• Assessing the overall value of a company often includes:
  • Valuation of Individual Assets and Liabilities
  • Valuation of Potential Earnings
  • Valuation of Consideration Exchanged

Valuation of Individual Assets and Liabilities

• The value of a company’s individual assets is usually determined by appraisal.
• Current liabilities are often viewed as having fair values equal to their book values because they will be paid at face amount within a short time.
• Long-term liabilities must be valued based on current interest rates if different from the effective rates at the issue dates of the liabilities.

Valuation of Potential Earnings

• Synergy occurs when assets operated together have a value that exceeds the sum of their individual values.
• This “going concern value” makes it desirable to operate the assets as an ongoing entity rather than sell them individually.
• Possible approaches to measuring the value of a company’s future earnings include:
  • Multiples of current earnings.
  • Present value of anticipated future new cash flows generated by the company.
  • Sophisticated financial models.

Valuation of Consideration Exchanged

• When one company acquires another, a value must be placed on the consideration given in the exchange.
• Little difficulty is encountered when cash is used in an acquisition, but valuation may be more difficult when securities are exchange, particularly illiquid or privately held securities or securities with unusual features (e.g., convertible or callable securities).

Accounting and Reporting Methods: SFAS No. 141, “Business Combinations”

• Prior to SFAS No. 141, there were two acceptable methods for reporting business combinations—the Purchase Method and the Pooling Method.
• SFAS No. 141 disallowed the use of the Pooling Method.
• Thus, the Purchase Method for reporting business combinations is currently the only allowable method under Generally Accepted Accounting Principles (GAAP).
Purchase Method (Current GAAP)

- The central idea underlying the purchase method is the same idea underlying the purchase of any asset or group of assets—there is a change in ownership control.
- That is, since there is a change in ownership control, the purchaser’s accounting is based on the fair value of the assets and liabilities—not the seller’s book values.

Pooling Method (Not Current GAAP)

- The central idea underlying the pooling method was opposite that of the purchase method—a continuity of interest.
- That is, the owners of the combining companies became the owners of the combined company.
- Thus, the book values of both companies were carried forward since there was not a change in ownership control (i.e., there was no arm’s length transaction to determine a “fair” fair value).

Purchase Method—Critical Concepts and Terms

- Cost of Investment (a.k.a. Cost or Investment Cost or Purchase Price)
- Goodwill
- Fair Value of Net Identifiable Assets
- Book Value of Net Identifiable Assets
- Excess of Cost over Fair Value of Net Identifiable Assets
- Excess of Fair Value over Book Value of Net Identifiable Assets
- Total Differential

Cost of Investment (a.k.a. Cost or Investment Cost or Purchase Price)

- The value of the consideration given to the owners of the acquired company normally constitutes the largest part of the total cost.
- There are three types of other costs that may be incurred in effecting a business combination:
  - Direct costs
  - Costs of issuing securities
  - Indirect and general costs

Purchase Price—Direct Costs

- All direct costs associated with purchasing another company are capitalized as part of the total cost of the acquired company.
- Examples:
  - Finders’ fees
  - Accounting fees
  - Legal fees
  - Appraisal fees

Purchase Price—Costs of Issuing Securities

- Costs incurred in issuing equity securities in connection with the purchase of a company should be treated as a reduction in the issue price of the equity securities issued. Examples include: Listing fees; Audit and legal fees related to the registration; and, Brokers’ commissions.
- Costs incurred in issuing bonds payable in connection with the purchase of a company should be accounted for as bond issue costs and amortized over the term of the bonds.
Purchase Price
--Indirect and General Costs

- All indirect and general costs related to a business combination or to the issuance of securities in a combination should be expensed as incurred.
- For example, the salary costs of accountants on the staff of the acquiring company in a business combination would be expensed, even though some of their time was spent on matters related to the combination.

Goodwill

- Any amount of the purchase price in excess of the fair value of the identifiable assets and liabilities acquired is viewed as the price paid for goodwill.
- In theory, goodwill is the excess earnings power of the acquired company.
- In practice, goodwill represents the premium paid to acquire control.

Subsequent Accounting for Goodwill

- Goodwill is carried forward to subsequent accounting periods at the original amount, without amortization, unless it becomes impaired.
- Goodwill must be evaluated for impairment at least annually, at the same time each year, and more frequently if events occur that are likely to impair the value of goodwill.

Bargain Purchase Price (a.k.a. Negative Goodwill)

- Negative goodwill is said to exist when a purchaser pays less than the fair value of the identifiable net assets of another company in acquiring its ownership.
- Negative goodwill is allocated as a pro rata reduction of the amounts that otherwise would have been assigned to all of the acquired assets with certain exceptions (e.g., current assets or deferred tax assets to name a few). Any amount remaining after reducing these acquired assets to zero would be recognized as an extraordinary gain.

Fair Value of Net Identifiable Assets and Book Value of Net Identifiable Assets

- Generally speaking, fair value is the amount that would be required to buy an asset (or refinance a liability) at the date of the business combination.
- Generally speaking, book value is the “GAAP historical cost” of the asset (or the monetary amount owed for liabilities—adjusted for premiums and discounts, if applicable).

Fair Value of Net Identifiable Assets and Book Value of Net Identifiable Assets-Cont’d

- Identifiable Asset: Generally speaking, assets other than Goodwill are considered identifiable.
- Identifiable Liability: Generally speaking, liabilities that are known (or, if probable, can be reasonably estimated) are considered identifiable.
"Excess Cost over Fair Value" and "Excess Fair Value over Book Value"

• Excess of Cost over Fair Value of Net Identifiable Assets EQUALS Cost of Investment LESS Fair Value of Net Identifiable Assets

• Excess of Fair Value over Book Value of Net Identifiable Assets EQUALS Fair Value of Net Identifiable Assets LESS Book Value of Net Identifiable Assets

Total Differential

• Two Possible Views:
  - Total Differential EQUALS Cost of Investment LESS Book Value of Net Identifiable Assets
  - Total Differential EQUALS Cost (of Investment) over Fair Value Net Identifiable Assets PLUS Fair Value over Book Value of Net Identifiable Assets

Example: Combination Effected through Purchase of Net Assets

• Point acquires the net assets of Sharp in a statutory merger by issuing Sharp 10,000 shares of $10 par common stock. The shares have a total market value of $600,000.

• Point incurs $40,000 in legal and appraisal fees and $25,000 in stock issuance costs.

• The net assets of Sharp have a total fair value of $510,000. (Do not worry about the individual fair values for now.)

Example: Combination Effected through Purchase of Net Assets (Cont’d.)

• Entries Recorded By Acquiring Company (Point)
  - To record costs related to purchase of Acquired Company (Sharp).
    Deferred Merger Costs $40,000
    Cash $40,000

• Entries Recorded By Acquiring Company (Point)
  - To record costs related to issuance of Point common stock to Sharp.
    Deferred Stock Issue Costs $25,000
    Cash $25,000

• Entries Recorded By Acquiring Company (Point)
  - To record the combination of Sharp by Point.
    Cash and Receivables $45,000 #
    Inventory 75,000 #
    Land, Buildings and Equipment 420,000 #
    Patent 80,000 #
    Goodwill 130,000 *
    Current Liabilities $110,000 #
    Common Stock 100,000
    Additional Paid-in Capital 475,000
    Deferred Merger Costs 40,000 **
    Deferred Stock Issue Costs 25,000 **

* See next slide.  **See previous two slides.
# Fair Market Value
Example: Combination Effected through Purchase of Net Assets (Cont’d.)

- Calculation of Goodwill
- Investment Cost:
  Fair value of stock issued $600,000
  PLUS: Other acquisition costs 40,000
  Total purchase price $640,000
- LESS:
  Fair value of net assets 510,000
  Goodwill $130,000

Example: Combination Effected through Purchase of Net Assets (Cont’d.)

Entries Recorded By Acquired Company (Sharp).
- To record the transfer of net assets to Point.
  Investment in Point Stock $600,000
  Current Liabilities 100,000
  Accumulated Depreciation 150,000
  Cash and Receivables $45,000
  Inventory 65,000
  Land 40,000
  Buildings and Equipment 400,000
  Gain on sale of Net Assets 300,000

Example: Combination Effected through Purchase of Net Assets (Cont’d.)

Entries recorded by acquired company (Sharp).
- To record the liquidation of Sharp.
  Common Stock $100,000
  Additional Paid-In Capital 50,000
  Retained Earnings 150,000
  Gain on Sale of Net Assets 300,000
  Investment in Point Stock $600,000

Example: Combination Effected through Purchase of Stock

- Point acquires all of the common stock of Sharp issuing the shareholders of Sharp 10,000 shares of $10 par common stock. The shares have a total market value of $600,000.
- Sharp continues to operate as a separate entity after the business combination transaction.
- Point incurs $40,000 in legal and appraisal fees and $25,000 in stock issuance costs.
- Do not worry about fair values for now.

Example: Combination Effected through Purchase of Stock

- Entries Recorded By Acquiring Company (Point)
  - To record costs related to purchase of Acquired Company (Sharp).
    Deferred Merger Costs $40,000
    Cash $40,000

- Entries Recorded By Acquiring Company (Point)
  - To record costs related to issuance of Point common stock to Sharp.
    Deferred Stock Issue Costs $25,000
    Cash $25,000
Example: Combination Effected through Purchase of Stock (Cont’d.)

• Entries Recorded By Acquiring Company (Point)
  – To record the combination of Sharp by Point.
    Investment in Sharp Stock $640,000 *
    Common Stock $100,000
    Additional Paid-In Capital 475,000
    Deferred Merger Costs 40,000 **
    Deferred Stock Issue Costs 25,000 **
  * $640,000 = $600,000 Fair Value of Point Common Stock PLUS $40,000 Merger Costs
  ** See previous two slides.

Example: Combination Effected through Purchase of Stock (Cont’d.)

• NOTE: With respect to the previous slide, identifiable assets and liabilities are not recorded at the date of the business combination since Sharp is not dissolved.

Additional Thoughts

• As previously stated, Sharp is not dissolved and continues to operate as a separate entity after the business combination transaction.

  • The accounting and reporting procedures for intercorporate investments in common stock where the acquired company continues in existence are discussed in the next nine chapters.

Financial Reporting Subsequent to a Purchase

• When a combination occurs during a fiscal year, income earned by the acquired company prior to the combination is not reported in the income statement of the combined entity.

  • If the combined entity reports comparative financial statements that include statements for periods before the combination, those statements include only the activities and financial statements of the acquiring company and not those of the acquired company.

Disclosure Requirements (a.k.a. Notes to the Financial Statements)

• A number of disclosures are required to provide financial statement readers with information about the combination. Examples include:
  • A description of the acquired entity.
  • The percentage voting interests acquired.
  • The primary reason for the acquisition.

  [Continued on next slide.]
ALWAYS ASK THESE QUESTIONS:

- Did the company acquire the common stock of another company or the assets of another company?
- Was the company dissolved (i.e., liquidated) or did the company continue to exist (i.e., survive)?
- Was a new company formed?
- Was there a change in ownership control?
- Is the acquired company wholly-owned?