TEST BANK
CHAPTER 2
Mergers and Acquisitions

MULTIPLE CHOICE

1. **Topic: Acquisition costs and goodwill**
LO 1, 2
Prolean Corporation acquired Setlan Company for $6,000,000. Setlan's book value was $2,000,000 at the date of acquisition. The $6,000,000 purchase price includes accounting and legal fees of $200,000. The book values of Setlan's assets and liabilities equaled their fair values, except for the following:

	Fair value	Book value
Inventory	$ 25,000	$40,000
Land	100,000	20,000

Goodwill reported for this acquisition is:

a. $3,735,000
b. $3,935,000
c. $3,800,000
d. $3,705,000

ANS: a

Cost	$ 5,800,000
Book value	2,000,000
Excess paid	$ 3,800,000
Inventory	15,000
Land	(80,000)
Goodwill	$ 3,735,000

2. **Topic: Bargain purchase**
LO 4
Pluto Corporation purchased Saturn Corporation's assets and liabilities for $15,000,000. Saturn's assets and liabilities consist of the following:

	Fair value Dr (cr)	Book value Dr (cr)
Cash, receivables	$ 6,000,000	$ 5,000,000
Inventory	9,000,000	8,000,000
Equipment	65,000,000	60,000,000
Liabilities	(63,000,000)	(63,000,000)

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The gain on acquisition is

a. $5,000,000.
b. $2,000,000.
c. $0.
d. $3,000,000.

ANS: b

Cost		$15,000,000
Fair value of identifiable net assets:		
Cash, receivables	6,000,000	
Inventory	9,000,000	
Equipment	65,000,000	
Liabilities	(63,000,000)	17,000,000
Gain		$ 2,000,000

3. **Topic: Bargain purchase**
LO 4
Titan Company pays $4,000,000 in cash to acquire Victory Company's assets and liabilities. Book and fair values of Victory's assets and liabilities appear below.

	Book value	**Fair value**
Current assets	$ 300,000	$ 400,000
HTM investments	100,000	600,000
Buildings, net	1,200,000	4,000,000
Equipment, net	2,000,000	6,000,000
Liabilities	2,000,000	2,000,000

What is the gain on acquisition?

a. $6,000,000
b. $0
c. $3,000,000
d. $5,000,000

ANS: d

Cost		$ 4,000,000
Fair value of net assets acquired		
Current assets	$ 400,000	
HTM investments	600,000	
Buildings	4,000,000	
Equipment	6,000,000	
Liabilities	(2,000,000)	9,000,000
Gain on acquisition		$(5,000,000)

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4. **Topic: Goodwill**
LO 1
X Company acquires all of Y Company's assets and liabilities, paying 80,000 shares of common stock with a fair value of $8,000,000. The fair values of Y's assets and liabilities approximate their book values, except Y has customer lists valued at $3,000,000 that are not reported on its balance sheet, and its plant assets are overvalued by $5,000,000. Here are the balance sheets of X and Y prior to the acquisition:

	X Company	**Y Company**
Assets	$30,000,000	$10,000,000
Liabilities	$16,000,000	$ 6,000,000
Common stock, $1 par	1,000,000	100,000
Additional paid-in capital	9,000,000	2,900,000
Retained earnings	4,000,000	1,000,000
	$30,000,000	$10,000,000

How much goodwill is recognized for this acquisition?

a. $ 2,000,000
b. $ 3,000,000
c. $ 6,000,000
d. $11,000,000

ANS: c

Cost		$8,000,000
Fair value of net assets acquired		
Reported assets	$ 5,000,000	
Customer lists	3,000,000	
Liabilities	(6,000,000)	2,000,000
Goodwill		$6,000,000

5. **Topic: Goodwill**
LO 1
P acquires all of S Company at an acquisition cost of $80,000,000. Assets and liabilities of the acquired company are as follows:

	Book value	Fair value
Current assets	$ 1,500,000	$ 1,700,000
Land, buildings and equipment (net)	16,000,000	17,500,000
Brand names	-0-	11,000,000
Liabilities	12,000,000	11,750,000

Goodwill arising from this acquisition is

a. $ 0
b. $61,550,000
c. $85,050,000
d. $74,500,000

ANS: b

$80,000,000 - ($1,700,000 + $17,500,000 + $11,000,000 - $11,750,000) = $61,550,000

6. **Topic: Changes in asset values subsequent to acquisition**
LO 3
Company Y is purchased by Company X, and the purchase price is $2,500,000 greater than the fair values of the identifiable net assets acquired. One of the assets acquired is a building, originally valued at $1,000,000 at the date of the purchase. Six months after the acquisition, it is discovered that the building was really only worth $200,000 at the date of acquisition. What entry is made to reflect this new information?

a. dr. goodwill, cr. building for $800,000.
b. dr. loss on building, cr. building for $800,000.
c. dr. other contributed capital, cr. building for $800,000.
d. dr. retained earnings, cr. building for $800,000.

ANS: a

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7. **Topic: Changes in asset values subsequent to acquisition**
LO 3
P Company assigned a fair value of $1,000,000 to land it acquired when it purchased S Company. Ten months later, P obtained information that the land was worth $700,000 at the date of acquisition. Two years after the acquisition, the land is worth $1,100,000. How does P account for these value changes?

a. Loss of $300,000, reported on the income statement; no recognition of increase in value to $1,100,000.
b. Increase goodwill by $300,000; no recognition of increase in value to $1,100,000.
c. Decrease goodwill by a net amount of $100,000.
d. Loss of $300,000 and gain of $400,000, reported on the income statement.

ANS: b

8. **Topic: Changes in asset values subsequent to acquisition**
LO 3
An acquirer made the following entry to report an acquisition:

Tangible assets		4,000	
Customer lists		600	
Goodwill		1,000	
	Liabilities		2,000
	Cash		3,600

Six months after the acquisition, the customer lists are determined to be worthless. How is this information reported if (1) the new information relates to the value of the customer lists as of the date of acquisition, and (2) the new information relates to changes in value since acquisition? Customer lists are written off, and

	(1)	(2)
a.	A gain on acquisition of $600 is recorded.	Goodwill decreases $600.
b.	Goodwill increases $600.	A loss of $600 is recorded.
c.	A loss of $600 is recorded.	Goodwill increases $600.
d.	Cash is reduced by $600.	A loss of $600 is recorded.

ANS: b

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9. **Topic: Valuation of assets acquired**
LO 1

Pyn Corporation acquires all of Sys Company at an acquisition cost of $90,000,000 in cash. Assets and liabilities of the acquired company are as follows:

	Book value	**Fair value**
Current assets	$ 500,000	$ 700,000
Land, buildings and equipment (net)	6,000,000	8,000,000
Brand names	0	2,000,000
Technically skilled workforce	0	15,000,000
Potentially profitable future contracts	0	10,000,000
Liabilities	2,000,000	1,750,000

Pyn records goodwill of

a. $71,050,000
b. $66,050,000
c. $56,050,000
d. $81,050,000

ANS: d

The entry to record the combination is *(in thousands)*:

Current assets		700	
Land, buildings & equipment		8,000	
Brand names		2,000	
Goodwill		81,050	
	Liabilities		1,750
	Cash		90,000

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Use the following information to answer questions 10 -12:

Kelly Corporation acquires Lawson Co. in a statutory merger. Below is the balance sheet of Lawson at the date of acquisition.

	Book value Dr(cr)	**Market value Dr(cr)**
Current assets	$ 1,000,000	$ 4,000,000
Plant & equipment	50,000,000	70,000,000
Identifiable intangibles	20,000,000	30,000,000
Goodwill	4,000,000	7,000,000
Current liabilities	(2,000,000)	(2,000,000)
Long-term liabilities	(52,000,000)	(52,000,000)
Capital stock	(3,000,000)	
Retained earnings	(18,000,000)	

10. **Topic: Net asset valuation, prior goodwill**
LO 1
Kelly issues stock with a market value of $58,000,000 for Lawson. How much goodwill does Kelly record?

a. $ 1,000,000
b. $ 7,000,000
c. $ 8,000,000
d. $10,000,000

ANS: c

$8,000,000 = $58,000,000 – ($4,000,000 + $70,000,000 + $30,000,000 - $2,000,000 - $52,000,000)

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11. **Topic: Subsequent changes in acquired asset values**
LO 3
Assume that three months after the acquisition, additional identifiable intangibles, belonging to Lawson at the date of acquisition, are discovered. These intangibles have a market value of $500,000. The entry to reflect this new information includes

a. a credit to goodwill of $500,000.
b. a credit to intangible assets of $500,000.
c. a gain of $500,000.
d. a loss of $500,000.

ANS: a

The correcting entry is:

Identifiable intangibles		500,000	
	Goodwill		500,000

12. **Topic: Subsequent changes in acquired asset values**
LO 3
Assume that a year after the acquisition, it is determined that because of a downturn in the economy and resulting reduction in sales, the acquired plant and equipment is only worth $60,000,000. The entry to reflect this new information includes

a. a debit to goodwill of $10,000,000.
b. a debit to plant and equipment of $10,000,000.
c. a gain of $10,000,000.
d. a loss of $10,000,000.

ANS: d

The correcting entry is:

Impairment loss		10,000,000	
	Plant & equipment, net		10,000,000

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Use the following information to answer questions 13 -16:

The balance sheet of Seattle Company, along with market values of its assets and liabilities, is as follows:

	Seattle Company	
	book value dr (cr)	**market value dr (cr)**
Current assets	$ 2,000,000	$ 1,500,000
Plant & equipment (net)	30,000,000	35,000,000
Patents	100,000	2,000,000
Completed technology	0	10,000,000
Broader customer base	0	16,000,000
Licensing agreements	0	4,000,000
Goodwill	200,000	700,000
Liabilities	(28,000,000)	(30,000,000)
Common stock, $10 par	(1,000,000)	
Additional paid-in capital	(5,000,000)	
Retained earnings	1,700,000	

13. **Topic: Asset valuation, goodwill**
LO 1
Portland Company pays $100,000,000 in cash for Seattle Company's assets and liabilities. Portland records goodwill of

a. $50,800,000
b. $66,800,000
c. $77,500,000
d. $61,500,000

ANS: c

$77,500,000 = $100,000,000 – ($1,500,000 + $35,000,000 + $2,000,000 + $10,000,000 + $4,000,000 - $30,000,000).

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14. **Topic: Asset valuation, goodwill, bargain purchase**
LO 1, 4
Now assume Portland Company pays $10,000,000 in cash to acquire the assets and liabilities of Seattle Company. Portland records a gain on acquisition of

a. zero
b. $12,500,000
c. $28,500,000
d. $29,200,000

ANS: b

$(12,500,000) = $10,000,000 – ($1,500,000 + $35,000,000 + $2,000,000 + $10,000,000 + $4,000,000 - $30,000,000).

15. **Topic: Subsequent value changes, acquired assets**
LO 3
Portland paid $100,000,000 in cash for Seattle. Three months later, Seattle's patents are determined to have been worthless as of the date of acquisition. The entry to record this information includes

a. a debit to loss of $2,000,000.
b. a debit to patents of $2,000,000.
c. A debit to goodwill of $2,000,000.
d. A debit to retained earnings of $2,000,000.

ANS: c

The correcting entry, within the measurement period, is:

Goodwill		2,000,000	
	Patents		2,000,000

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16. **Topic: Subsequent value changes, acquired liabilities**
LO 3
Portland paid $10,000,000 in cash for Seattle. Three months later, it is determined that Seattle's acquisition-date liabilities omitted a pending lawsuit valued at $2,000,000. The entry to record this information includes

a. a debit to gain on acquisition of $2,000,000.
b. a debit to liabilities of $2,000,000.
c. A debit to goodwill of $2,000,000.
d. A debit to retained earnings of $2,000,000.

ANS: a

The correcting entry, within the measurement period, is:

Gain on acquisition		2,000,000	
	Liabilities		2,000,000

17. **Topic: Stock price contingency**
LO 2
Peters Corporation acquires all of the voting shares of Stefan Company by issuing 500,000 shares of $1 par common stock valued at $10,000,000. Included in the agreement is a contingency guaranteeing the former shareholders of Stefan that Peters' shares will be worth at least $18 per share after one year. If the shares are worth less, Peters will pay the former shareholders of Stefan enough cash to reimburse them for the decline in value below $18 per share. Peters estimates that there is a 5% chance that the stock value will be $16 at the end of one year, and a 95% chance that the stock value will be $18 per share or higher. A discount rate of 10% is appropriate. What is the value of the stock price contingency at the date of acquisition?

a. $1,000,000
b. $ 45,455
c. $ 50,000
d. $ 863,636

ANS: b

[($18 - $16) x 500,000] x .05 = $50,000/1.10 = $45,455

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Use the following information to answer questions 18-23 below.

Southern Company's balance sheet is as follows:

Current assets	$ 12,000,000
Plant & equipment	150,000,000
Total	$162,000,000
Liabilities	$130,000,000
Common stock, $1 par	400,000
Additional paid-in capital	23,800,000
Retained earnings	(10,000,000)
Treasury stock, 6,000 shares	(400,000)
Accumulated OCI	18,200,000
Total	$162,000,000

Pecan Corporation is in the process of acquiring Southern. Its research reveals that Southern's current assets are carried at $2,000,000 more than book value, its plant & equipment is carried at $60,000,000 more than book value, and it has the following unreported intangibles:

	Fair value
Non-competition agreement	$ 8,000,000
Skilled employees	4,000,000
Business from prospective customers	16,000,000
Order backlog	30,000,000

Pecan includes an earnings contingency, with a present value of $1,000,000, as part of the acquisition agreement.

18. **Topic: Acquisition financing, stock price contingency**
LO 2
Pecan finances the acquisition with bonds. If Southern's shareholders are to receive $72 per share in cash on acquisition, how much cash must Pecan generate from the sale of bonds?

a. $14,400,000
b. $28,800,000
c. $28,368,000
d. $30,368,000

ANS: c

Southern has 400,000 – 6,000 = 394,000 shares outstanding. 394,000 x $72 = $28,368,000.

19. **Topic: Unreported intangibles, earnings contingency, goodwill**
LO 1, 2
How much cash must Pecan generate from the sale of bonds, if it wants to report $40,000,000 in goodwill?

a. $47,000,000
b. $48,000,000
c. $43,000,000
d. $28,000,000

ANS: a

Fair value of identifiable net assets acquired = $10,000,000 + $90,000,000 + $8,000,000 + $30,000,000 - $130,000,000 = $8,000,000.
To report $40,000,000 in goodwill, the total acquisition cost must be $48,000,000. The earnings contingency is $1,000,000, so $47,000,000 in cash must be paid.

20. **Topic: Goodwill**
LO 1
Pecan pays $60,000,000 in cash to the former shareholders of Southern. How much goodwill does it record?

a. $52,000,000
b. $53,000,000
c. $33,000,000
d. $17,000,000

ANS: b

Fair value of identifiable net assets acquired = $10,000,000 + $90,000,000 + $8,000,000 + $30,000,000 - $130,000,000 = $8,000,000.
Acquisition cost = $60,000,000 + $1,000,000 = $61,000,000.
Goodwill = $61,000,000 - $8,000,000 = $53,000,000

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21. **Topic: Subsequent value changes, acquired assets**
LO 3
Pecan pays $60,000,000 in cash to the former shareholders of Southern. Subsequent information reveals that Southern has customer lists, not reported on its balance sheet, with a fair value of $3,000,000 at the date of acquisition. This information was received during the measurement period. The entry to record the new information includes a credit of $3,000,000 to

a. intangible assets.
b. goodwill.
c. gain on acquisition.
d. additional paid-in capital.

ANS: b

Initial fair value of identifiable net assets acquired = $10,000,000 + $90,000,000 + $8,000,000 + $30,000,000 - $130,000,000 = $8,000,000.
Acquisition cost = $60,000,000 + $1,000,000 = $61,000,000.
Initial goodwill = $61,000,000 - $8,000,000 = $53,000,000
When the additional intangible is discovered, goodwill declines to $50,000,000 since the fair value of identifiable net assets increases to $11,000,000.

22. **Topic: Earnings contingency, subsequent value changes**
LO 3
Pecan pays $60,000,000 in cash to the former shareholders of Southern. Assume the fair values of Southern's identifiable net assets are as originally stated. Within the measurement period, additional information on Southern's expected future performance at the date of acquisition reveals that the earnout had a fair value of $200,000 at the date of acquisition. The entry to record the new information includes a credit of $800,000 to

a. intangible assets.
b. goodwill.
c. gain on acquisition.
d. earnings contingency liability.

ANS: b

Initial fair value of identifiable net assets acquired = $10,000,000 + $90,000,000 + $8,000,000 + $30,000,000 - $130,000,000 = $8,000,000.
Initial acquisition cost = $60,000,000 + $1,000,000 = $61,000,000.
Initial goodwill = $61,000,000 - $8,000,000 = $53,000,000
When the fair value of the earnout declines, the acquisition cost declines to $60,200,000, and goodwill declines to $52,200,000 = $60,200,000 - $8,000,000.

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23. **Topic: Earnings contingency, subsequent value changes**
LO 3
Pecan pays $60,000,000 in cash to the former shareholders of Southern. Assume the fair values of Southern's identifiable net assets are as originally stated. Subsequent increases in the demand for Southern's products requires that the earnout be revalued to $1,800,000. The entry to record the new information includes a debit of $800,000 to

a. intangible assets.
b. goodwill.
c. loss on contingency.
d. earnings contingency liability.

ANS: c

The change in earnout value is due to subsequent events and is therefore not a correction of the initial acquisition entry. The entry to record the revaluation is:

Loss on contingency		800,000	
	Earnings contingency liability		800,000

24. **Topic: Acquisition cost and goodwill**
LO 1, 2
A company acquires the assets and liabilities of another company. The fair value of the acquired company's identifiable net assets is $5,000,000. The acquisition transaction includes the following:

- $5,000,000 in cash paid to the former owners of the acquired company.
- 150,000 new shares of stock with a market value $45/share. Registration fees, paid in cash, were $1,000,000.
- $4,000,000 in cash paid to the underwriter for consulting services.
- Earnings contingency with a expected present value of $3,000,000 at the date of acquisition.

Goodwill for this acquisition is

a. $11,750,000.
b. $14,750,000.
c. $10,750,000.
d. $ 9,750,000.

ANS: d

Acquisition cost = $5,000,000 + (150,000 x $45) + $3,000,000 = $14,750,000
Goodwill = $14,750,000 - $5,000,000 = $9,750,000.

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25. **Topic: IPR&D and preacquisition contingencies**
LO 5

Pawan Corporation acquires all of Sesa Company at an acquisition cost of $100,000,000 in cash. Sesa's reported assets and liabilities are as follows:

	Book value Dr(cr)	**Fair value Dr(cr)**
Current assets	$ 5,000,000	$ 7,000,000
Land, buildings and equipment (net)	60,000,000	80,000,000
Liabilities	(40,000,000)	(41,000,000)

Pawan determines that Sesa has the following intangible assets, not reported on its balance sheet:

	Fair value
Favorable leaseholds	$ 4,000,000
In-process research & development	10,000,000
Skilled workforce	25,000,000
Advertising contracts	8,000,000

Pawan also discovers that Sesa has not properly recorded the expected liability from a pending lawsuit, currently estimated at $6,000,000.

Pawan records goodwill of

a. $13,000,000.
b. $26,000,000.
c. $28,000,000.
d. $38,000,000.

ANS: d

The entry to record the combination is

Current assets		7,000,000	
Land, buildings & equipment		80,000,000	
Favorable leaseholds		4,000,000	
In-process R&D		10,000,000	
Advertising contracts		8,000,000	
Goodwill		38,000,000	
	Liabilities		47,000,000
	Cash		100,000,000

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26. **Topic: Bargain gain**
LO 4
A gain should be reported on an acquisition if

a. the fair value of the consideration paid is less than the book value of the net assets acquired.
b. the fair value of the consideration paid plus the present value of any earnings contingency is less than the book value of the net assets acquired.
c. the fair value of the consideration paid is less than the fair value of net assets acquired plus the fair value of identifiable intangibles acquired.
d. the fair value of the consideration paid plus the present value of any earnings contingency is less than the fair value of identifiable net assets acquired.

ANS: d

27. **Topic: In-process research and development**
LO 5
Company P acquires all of the stock of Company S. How are Company S's research and development costs of ongoing projects reported at the date of acquisition?

a. Asset, at fair value.
b. Asset, at S's cost.
c. Expense, at fair value.
d. Expense, at S's cost.

ANS: a

28. **Topic: Out-of-pocket merger costs, contingent liabilities**
LO 1, 2
Company P acquires all of the stock of Company S. The consideration paid includes consulting, accounting, and legal fees, and there are previously unreported lawsuits pending against Company S. What effect will these two items have on the **amount of goodwill** reported on the acquisition?

	Fees	Lawsuits
a.	No effect	Decrease
b.	Increase	Decrease
c.	No effect	Increase
d.	Decrease	Increase

ANS: c

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29. **Topic: Security price contingency**
LO 2
An acquirer includes a stock price contingency in the acquisition price. Additional cash will be paid to the former owners of the acquired company if the acquirer's stock price falls below its current value within the next three years. The payoff, if any, would occur three years after the acquisition. Which of the following statements is *true*?

a. The stock price contingency is not reported at the date of acquisition, but will be reported as an adjustment to the acquisition price if and when paid.
b. The stock price contingency is reported as a liability on the acquired company's books at the date of acquisition.
c. If the discount rate increases, the date-of-acquisition stock price contingency value increases.
d. The stock price contingency usually increases reported goodwill at the date of acquisition.

ANS: d

30. **Topic: Intangible assets acquired**
LO 1
Which of the following is ***least*** likely to be reported as an acquired identifiable intangible?

a. In-process research & development
b. synergies in developing future products
c. production processes
d. broadcast rights

ANS: b

31. **Topic: Bargain gain**
LO 4
The acquiring company reports a gain on acquisition if the acquisition cost is less than the fair value of the identifiable net assets acquired. This could motivate companies to overstate the gain so they would look better financially. How could companies overstate the gain?

a. Leave acquired identifiable net assets at book value as reported by the acquired company, and categorize the excess acquisition cost paid as goodwill.
b. Understate the discount rate used to measure acquired liabilities.
c. Overstate the value of previously unreported intangibles acquired.
d. Overstate the value of acquired contingent liabilities such as pending lawsuits.

ANS: c

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32. **Topic: Out-of-pocket merger costs**
LO 2
In 2009, the FASB changed the reporting for out-of-pocket costs of outside merger and acquisition advisory services. This change, as compared with previous GAAP,

a. reduces reported goodwill.
b. increases cash paid for the acquisition.
c. reduces additional paid-in capital on stock issued in the acquisition.
d. increases bargain gains.

ANS: a

33. **Topic: Acquisition cost, earnings contingency**
LO 2
ABC Corporation acquires all of the assets and liabilities of XYZ Company in a statutory merger. If ABC offers the former shareholders of XYZ an earnings contingency, what is the likely result of having this contingency, on ABC's balance sheet?

a. ABC will report more goodwill.
b. ABC will revalue XYZ's previously reported assets at higher amounts.
c. ABC will revalue XYZ's liabilities at higher amounts.
d. There is no effect on how ABC reports the assets and liabilities acquired from XYZ.

ANS: a

34. **Topic: IFRS for business combinations**
LO 1, 2
Which statement is *true* concerning IFRS reporting for business combinations?

a. IFRS allows capitalization of in-process development.
b. IFRS does not allow capitalization of in-process research.
c. IFRS does not allow recognition of earnouts.
d. IFRS uses the contractual but not the separability criteria for capitalization of identifiable intangibles.

ANS: a

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35. **Topic: In-process research and development**
LO 5
In a business combination, an acquiree's previously unreported in-process R&D

a. decreases goodwill.
b. decreases identifiable intangibles.
c. adds to expenses.
d. has no effect.

ANS: a

36. **Topic: Preacquisition contingency, change in estimate**
LO 3, 5

ABC Corporation acquires XYZ Company in a statutory merger, and pays an amount significantly above the fair value of the identifiable net assets acquired. At the time of the acquisition, XYZ was a defendant in a customer's lawsuit, but it was expected that XYZ would win, so the lawsuit was not recorded. Within a year of the acquisition, the lawyers persuade both parties to settle out of court for $8,000,000. How is this payment most likely to be reported? Credit cash, and debit

a. retained earnings (balance sheet).
b. accumulated other comprehensive income (balance sheet).
c. loss (income statement).
d. lawsuit liability (balance sheet).

ANS: c

37. **Topic: Valuation of assets acquired and liabilities assumed**
LO 1
Company A has unreported intangible assets that are very valuable. Which one of the following actions will allow these intangible assets to be reported?

a. Get a third party appraisal of the intangible assets.
b. Reclassify Company A's reported plant and equipment as intangible assets.
c. Find a company to combine with, and designate Company A as the acquirer.
d. Find a company to combine with, and designate Company A as the company being acquired.

ANS: d

38. **Topic: Valuation of assets acquired and liabilities assumed**
LO 1
A new company, DEF, is formed to acquire all of the assets and liabilities of ABC and XYZ, in a transaction classified as a statutory consolidation. How will the assets and liabilities of ABC and XYZ be valued on the balance sheet of DEF, immediately following the merger?

a. The assets and liabilities of both ABC and XYZ remain at book value.
b. If ABC is identified as the acquiring company, the assets and liabilities of ABC remain at book value, while the assets and liabilities of XYZ are revalued to market value.
c. If ABC is identified as the acquiring company, the assets and liabilities of ABC are revalued to market value while the assets and liabilities of XYZ remain at book value.
d. The assets and liabilities of both ABC and XYZ are revalued to market value.

ANS: b

39. **Topic: Subsequent changes in values of assets acquired, bargain gain**
LO 3, 4
Acquirer Corporation reports a bargain gain of $2 million on acquisition of Target Company. Subsequently, Acquirer learns that one of Target's patents, valued at $1 million, is worthless. How is this reported? Assume the information is discovered (1) within the measurement period, and (2) after the measurement period is over.

	(1) Within the measurement period	**(2) After the measurement period**
a.	Increase in goodwill	Loss on the income statement
b.	Decrease in bargain gain	Loss on the income statement
c.	Loss on the income statement	Decrease in bargain gain
d.	Increase in goodwill	Decrease in bargain gain

ANS: b

40. **Topic: Acquisition cost**
LO 2
ABC Corporation issues new stock to the former shareholders of XYZ Company, in a statutory merger. If ABC must pay registration fees to issue the new stock, how is this reported by ABC?

a. ABC will report more goodwill.
b. ABC will report an expense in the amount of the registration fees.
c. ABC will report more previously unreported identifiable intangible assets acquired.
d. ABC's total acquisition cost is not affected.

ANS: d

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41. **Preacquisition contingency**
LO 5
Acquirer Corporation is acquiring Target Company. Acquirer's valuation team discovers that a competitor has filed a patent infringement lawsuit against Target. This lawsuit is not currently recognized on Target's books. How should Acquirer report the lawsuit at the date it acquires Target?

a. Don't report it until it is settled.
b. Report it as a liability if it is a probable liability and its value can be reasonably estimated.
c. Report it as a liability if it is a contractual or separable obligation.
d. Report it as a liability if Target's management estimates that there is an 80% or higher probability that Target will lose the lawsuit.

ANS: b

42. **Topic: Goodwill recognition**
LO 1
Which one of the following items is most likely to be reported as goodwill?

a. skilled workforce
b. brand names
c. developed technology
d. in-process research and development

ANS: a

43. **Topic: In-process research and development**
LO 5
If an acquiring company attributes some of the purchase price to in-process R&D, the amount is reported as

a. an extraordinary expense on the income statement.
b. an asset on the balance sheet.
c. an operating expense on the income statement.
d. a reduction in accumulated other comprehensive income on the balance sheet.

ANS: b

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44. **Topic: Bargain gain**
LO 4
If an acquiring company pays less than the fair value of the identifiable assets less liabilities acquired, the difference is

a. debited to accumulated other comprehensive income.
b. credited to accumulated other comprehensive income.
c. reported as a loss on the income statement.
d. reported as a gain on the income statement.

ANS: d

45. **Topic: In-process research and development**
LO 5
Before 2009, some companies (notably Kodak) paid amounts greatly in excess of book value to acquire other companies, and under previous reporting standards attributed much of this excess price paid to the acquired company's in-process R&D. Why was this considered preferable to allocating it to tangible assets or to goodwill?

a. The consolidated debt/equity ratio would be lower.
b. Future consolidated income would be higher.
c. Consolidated total assets would be higher.
d. It would then not be necessary to report consolidated financial statements.

ANS: b

46. **Topic: Identifiable intangible assets acquired**
LO 1
All of the following are examples of reportable identifiable intangible assets acquired in a business combination, except:

a. mineral rights
b. customer lists
c. advertising jingles
d. business reputation

ANS: d

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47. **Topic: Earnings contingency**
LO 2
If a company is negotiating an earnout as part of its acquisition price, you would recommend all of the following *except*:

a. The acquired company's performance should be easy to separate from the performance of the acquiring company.
b. Be sure to factor out the effect of the acquiring company on the performance of the acquired company.
c. Be sure that the terms of the earnout are unambiguous.
d. It is preferable to use an overall measure of performance such as net income, rather than revenues or gross margin.

ANS: d

48. **Topic: Subsequent event**
LO 3
ABC Corporation acquires all of the assets and liabilities of XYZ Company, at a price that is significantly higher than the fair value of the identifiable net assets acquired. After the acquisition, a fire destroys some of XYZ's property. How does ABC report this?

a. ABC will report less goodwill from the acquisition.
b. ABC will report more goodwill from the acquisition.
c. ABC will not report this event.
d. ABC will report a loss on property.

ANS: d

49. **Topic: Acquisition costs**
LO 2
Which one of the following items ***increases*** the amount of goodwill recognized in an acquisition?

a. Consulting fees paid to Goldman Sachs
b. During the measurement period, it is determined that the acquired company's favorable leaseholds are really worth more than originally estimated.
c. An earnout is added to an acquisition agreement to motivate the acquired company's shareholders to sell.
d. Registration fees the acquiring company pays to issue new stock in an acquisition.

ANS: c

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50. **Topic: Acquisition costs**
LO 2
All of the following increase the acquisition cost of the acquired company **except**:

a. fair market value of stock issued
b. fair market value of debt issued
c. costs of registering and issuing equity securities
d. stock price contingency

ANS**:** c

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PROBLEMS

1. **Topic: Valuation of assets and liabilities, acquisition cost, goodwill and bargain gain LO 1, 2, 4**

Mars Inc. acquires all of Wrigley Co.'s assets and liabilities on January 1, 2009. Mars incurs the following costs for the acquisition:

50,000,000 shares of new Mars common stock, par value $2/share, market value $80/share, issued to the former stockholders of Wrigley	$ 4,000,000,000	Fair value of stock issued
Registration fees connected with issuing the new shares, paid in cash	500,000,000	Cash payment
Cash paid to former stockholders of Wrigley: there were 200,000,000 shares of Wrigley outstanding, and Mars agreed to pay $90 in cash for each share of outstanding Wrigley stock	18,000,000,000	Cash payment
Consulting fees paid to Goldman Sachs, in cash	1,100,000,000	Cash payment

The balance sheets of both companies *immediately prior to* the acquisition are as follows:

(in thousands)	**Mars Inc.**		**Wrigley Co.**	
Assets	**book value**		**book value**	**fair value**
Cash	$ 25,000,000		$ 90,000	$ 90,000
Receivables	2,000,000		200,000	190,000
Inventories	20,000,000		8,110,000	7,000,000
Plant & equipment, net	99,500,000		50,000,000	40,000,000
Trademarks	5,000,000		1,000,000	4,000,000
Total assets	$151,500,000		$ 59,400,000	
Liabilities & equity				
Current liabilities	$ 500,000		$ 400,000	400,000
Long-term liabilities	70,000,000		45,000,000	47,000,000
Common stock, par	2,000,000		1,000,000	
APIC	55,000,000		10,000,000	
Retained earnings	25,000,000		6,000,000	
Treasury stock	(1,000,000)		(3,000,000)	
Total liabilities & equity	$151,500,000		$ 59,400,000	

In addition to the assets and liabilities already reported, Wrigley has the following previously unrecorded intangible assets that meet the requirements for capitalization *(in thousands)*:

Intangible asset	**Fair value**
Brand names	$ 5,000,000
Secret formulas	7,000,000

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Required

a. Prepare the journal entry or entries to record the acquisition on Mars' books.

b. Assume the same information as above, but Wrigley has an additional previously unreported intangible that meets the requirements for capitalization: a noncompetition agreement with a fair value of $10,000,000,000. All fair value calculations have been double checked for accuracy and found to be correct. Make the journal entry or entries to record the acquisition on Mars' books.

ANS:

(in millions)

a.

Cash		90	
Receivables		190	
Inventories		7,000	
Plant & equipment		40,000	
Trademarks		4,000	
Brand names		5,000	
Secret formulas		7,000	
Goodwill		6,120	
Merger expenses		1,100	
	Current liabilities		400
	Long-term liabilities		47,000
	Cash		19,600
	Common stock		100
	APIC		3,400

b.

Cash		90	
Receivables		190	
Inventories		7,000	
Plant & equipment		40,000	
Trademarks		4,000	
Brand names		5,000	
Secret formulas		7,000	
Noncompetition agreements		10,000	
Merger expenses		1,100	
	Current liabilities		400
	Long-term liabilities		47,000
	Cash		19,600
	Common stock		100
	APIC		3,400
	Gain on acquisition		3,880

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2. **Topic: Earnings contingency**
LO 2
To induce the owners of Isolevel Company to sell to Axima Corporation, an earnout was included in the acquisition agreement. Axima agrees to pay the former owners of Isolevel $5.00 for every dollar of total EBITDA earned over $20 million in the next four years. The payment would be made at the end of four years. Expected total EBITDA in the next four years is as follows:

Total EBITDA earned	Probability
$ 5,000,000	0.20
15,000,000	0.50
30,000,000	0.20
35,000,000	0.10

Required
What is the value of the earnout at the date of acquisition, assuming a discount rate of 12%? Round your answer to the nearest dollar.

ANS:

10,000,000 x $5 x 0.20	$ 10,000,000
15,000,000 x $5 x 0.10	7,500,000
	$17,500,000
$17{,}500{,}000/(1.12)^4$	$11,121,566

3. **Topic: Valuation of assets acquired and liabilities assumed**
LO 1, 2
InBev paid $50,000 million in cash to acquire Anheuser-Busch on January 1, 2009. Information on Anheuser-Busch's assets and liabilities at the date of acquisition was as follows *(all amounts in millions)*:

Anheuser-Busch	Book value	Fair value
Current assets	$ 2,000	$ 3,100
Property, plant & equipment	10,000	8,000
Trademarks and beer distribution rights	5,000	9,000
Total assets	$ 17,000	
Current liabilities	$ 2,000	$ 2,000
Long-term debt	11,700	11,700
Common stock, $1 par	1,500	
Additional paid-in capital	3,400	
Retained earnings	18,000	
Other comprehensive income	(19,600)	
Total liabilities & equity	$ 17,000	

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InBev's consultants found the following items which were not reported on Anheuser-Busch's balance sheet:

	Fair value
Customer contracts	$ 1,000
Trade secrets	3,000
Potential contracts with new customers	4,000
Advertising jingles	500
Future cost savings	2,600

Required
Prepare the journal entry InBev made to record the acquisition of Anheuser-Busch's assets and liabilities.

ANS:

Current assets		3,100	
Property, plant & equipment		8,000	
Trademarks, etc.		9,000	
Customer contracts		1,000	
Trade secrets		3,000	
Advertising jingles		500	
Goodwill		39,100	
	Current liabilities		2,000
	Long-term debt		11,700
	Cash		50,000

4. **Topic: Valuation of assets acquired and liabilities assumed, measurement of acquisition cost, change in value of assets acquired, preacquisition contingency, in-process R&D**
LO 1, 2, 3, 5
Serano Corporation's balance sheet at January 2, 2014 is as follows:

(in millions)	**Serano Dr (Cr)**
Cash and receivables	$ 200
Inventories	600
Property, plant and equipment, net	7,500
Current liabilities	(400)
Long-term debt	(7,200)
Capital stock	(720)
Retained earnings	25
Accumulated other comprehensive income	(5)

An analysis of Serano's assets and liabilities reveals that book values of some reported items do not reflect their market values at the date of acquisition *(in millions)*:

< Inventories are overvalued by $200
< Property, plant and equipment is overvalued by $2,000
< Long-term debt is undervalued by $100

In addition, the following items are not currently reported on Serano's balance sheet:

< Customer contracts, valued at $25
< Skilled work force, valued at $45
< In-process research and development, valued at $300
< Potential contracts with prospective customers, valued at $15
< Serano has not recorded expected future warranty liabilities with a present value of $10.

All numbers below are in millions.

On January 2, 2014, Pago issues new stock with a market value of $700 to acquire the assets and liabilities of Serano. Stock registration fees are $100, paid in cash. Consulting, accounting, and legal fees connected with the merger are $150, paid in cash. In addition, Pago enters into an earnings contingency agreement, whereby Pago will pay the former shareholders of Serano an additional amount if Serano's performance meets certain minimum levels. The present value of the contingency is estimated at $50.

Required

a. Make the journal entry or entries Pago makes to record the acquisition.

b. Now assume that during March, 2014, new information comes in regarding the value of Serano's property, plant and equipment at the date of acquisition. It is determined that the property was actually worth $1,500 less than previously estimated. Make the entry to record this new information.

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ANS:

a.

Cash and receivables		200	
Inventories		400	
Property, plant & equipment		5,500	
Customer contracts		25	
In-process R&D		300	
Goodwill		2,035	
Merger expenses		150	
	Current liabilities		400
	Long-term debt		7,300
	Warranty liability		10
	Cash		250
	Earnings contingency liability		50
	Capital stock		600

b.

Goodwill		1,500	
	Property, plant & equipment		1,500

5. **Topic: Valuation of assets acquired and liabilities assumed**
LO 1

Delta Airlines' June 1, 2008 balance sheet is as follows *(in millions)*:

Assets		**Liabilities & equity**	
Cash	$ 1,400	Current liabilities	$ 3,200
Receivables	650	Long-term debt	5,000
Investments	1,000	Common stock, $.01 par	1
Maintenance supplies	150	Additional paid-in capital	5,500
Flight equipment (net of $2,000 accumulated depreciation)	8,500	Retained earnings (deficit)	(2,300)
International routes	700	Accumulated other comprehensive income	1,999
	______	Treasury stock	(1,000)
Total	$12,400		$12,400

Northwest Airlines acquired Delta on June 1, 2008. Northwest accounted for the acquisition by putting Delta's assets and liabilities directly on its own books. Delta's cash and receivables, investments, and current liabilities were reported at market value. Its maintenance supplies had a fair value of $400 million, flight equipment had a fair value of $12,000 million, and international routes were worth $500 million. Long-term debt had a fair value of $6,000 million. Delta also had an unrecorded intangible, representing leases with favorable terms, worth $800 million. Northwest paid $8,000 million in cash for Delta.

Required
Present Northwest's journal entry to record the acquisition.

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ANS:

Cash		1,400	
Receivables		650	
Investments		1,000	
Maintenance supplies		400	
Flight equipment		12,000	
International routes		500	
Leases		800	
Goodwill		450	
	Current liabilities		3,200
	Long-term debt		6,000
	Cash		8,000

6. **Topic: Valuation of assets and liabilities, acquisition cost, goodwill and bargain purchase, earnings contingency**
LO 1, 2, 4
Schenk Corporation's balance sheet *immediately prior* to its acquisition by Piaget Company is as follows:

	Schenk Corporation	
Assets	**book value**	**market value**
Current assets	$ 3,000,000	$ 2,500,000
Plant & equipment, net	24,000,000	15,000,000
Total assets	$ 27,000,000	
Liabilities & equity		
Current liabilities	$ 3,220,000	3,220,000
Long-term liabilities	20,000,000	19,800,000
Common stock	60,000	
Additional paid-in capital	3,400,000	
Treasury stock	(500,000)	
Retained earnings	900,000	
AOCI	(80,000)	
Total liabilities & equity	$ 27,000,000	

In addition to the assets already reported by Schenk, the following previously unreported identifiable intangible assets are identified as owned by Schenk Corporation. These assets are appropriately recorded by Piaget as assets.

Identifiable intangible asset	**Market Value**
Customer contracts	$ 6,000,000
Leaseholds	9,000,000

Piaget Company issues 200,000 shares of new $1 par common stock with a market value of $80/share to acquire Schenk's assets and liabilities. Stock registration fees are $350,000 and costs for the services of outside accountants and lawyers are $400,000, both paid in cash.

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Required

a. Prepare Piaget's entry to record the acquisition.

b. Now assume Piaget Company issues 50,000 shares of $1 par common stock with a market value of $80/share to acquire Schenk's assets and liabilities. Registration fees for the stock issue are $150,000 and out of pocket costs for the services of outside accountants and lawyers are $200,000, both paid in cash. The terms of the merger include an earnings contingency. Piaget Company estimates the expected present value of the payout on the earnings contingency to be $300,000. Prepare Piaget's entry to record the acquisition.

ANS:

a.

Current assets		2,500,000	
Plant & equipment		15,000,000	
Customer contracts		6,000,000	
Leaseholds		9,000,000	
Goodwill		6,520,000	
Merger expenses		400,000	
	Current liabilities		3,220,000
	Long-term liabilities		19,800,000
	Common stock		200,000
	APIC		15,450,000
	Cash		750,000

b.

Current assets		2,500,000	
Plant & equipment		15,000,000	
Customer contracts		6,000,000	
Leaseholds		9,000,000	
Merger expenses		200,000	
	Current liabilities		3,220,000
	Long-term liabilities		19,800,000
	Earnings contingency liability		300,000
	Common stock		50,000
	APIC		3,800,000
	Cash		350,000
	Gain on purchase		5,180,000

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7. **Topic: Valuation of assets acquired and liabilities assumed, acquisition cost LO 1, 2**

Dr Pepper Snapple Group (DPSG) acquired the assets and liabilities of Turquoise Water Inc. on September 30, 2013, in a statutory merger. The acquisition involves the following payments:

Cash paid to Turquoise Water	$ 85,000,000
Cash paid to Morgan Stanley for consulting services	12,000,000
New stock issued, 100,000 shares, $0.50 par, fair value at acquisition	5,000,000
Stock registration fees, paid in cash	600,000
Earnings contingency, to be paid in three years, present value	2,000,000

Turquoise Water's balance sheet just prior to the acquisition appears below. Fair value information on Turquoise Water's assets and liabilities is also provided.

		Turquoise Water, Inc.	
Assets		**Book value**	**Fair value**
Current assets		$ 1,000,000	$ 800,000
Plant and equipment, net		41,000,000	10,000,000
Patents and trademarks		3,400,000	20,000,000
Total assets		$ 45,400,000	
Liabilities & equity			
Current liabilities		$ 400,000	400,000
Long-term liabilities		40,000,000	41,000,000
Common stock, par value		500,000	
Additional paid-in capital		8,500,000	
Retained earnings		(2,000,000)	
Accumulated OCI		(1,400,000)	
Treasury stock		(600,000)	
Total liabilities & equity		$ 45,400,000	

In addition to the assets reported on Turquoise Water's balance sheet, the following previously unreported intangible assets are identified:

	Fair value
Bottlers' franchise rights	$ 10,400,000
Skilled workforce	15,000,000
Non-competition agreements	4,000,000
Expected expansion into new product lines	5,000,000
Order backlogs	2,000,000

Required

a. Prepare the journal entry DPSG makes to record this acquisition.

b. Now assume DPSG acquires all of the stock of Turquoise Water. Prepare the journal entry DPSG makes to record this stock acquisition.

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ANS:

a.

Current assets		800,000	
Plant and equipment		10,000,000	
Patents and trademarks		20,000,000	
Bottlers' franchise rights		10,400,000	
Non-competition agreements		4,000,000	
Order backlogs		2,000,000	
Merger expenses		12,000,000	
Goodwill		86,200,000	
	Current liabilities		400,000
	Long-term liabilities		41,000,000
	Cash		97,600,000
	Common stock, par		50,000
	Additional paid-in capital		4,350,000
	Earnout liability		2,000,000

b.

Investment in Turquoise Water		92,000,000	
Merger expenses		12,000,000	
	Cash		97,600,000
	Common stock, par		50,000
	Additional paid-in capital		4,350,000
	Earnout liability		2,000,000

8. **Topic: Valuation of assets acquired and liabilities assumed, acquisition cost**
LO 1, 2

Bellnorth Co's January 1, 2014 balance sheet is as follows:

Assets		**Liabilities & equity**	
Cash	$ 1,000,000	Current liabilities	$ 2,000,000
Receivables	2,000,000	Long-term liabilities	5,000,000
Inventories	3,000,000	Common stock	500,000
Investments	500,000	Additional paid-in capital	4,000,000
Plant & equipment	8,000,000	Retained earnings	2,950,000
Land	100,000	Accumulated other comprehensive income	600,000
		Treasury stock	(450,000)
Total	$14,600,000	Total	$14,600,000

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On January 1, 2014, A&T Corporation acquires Bellnorth's assets and liabilities. Bellnorth's cash, receivables, inventories, investments and current liabilities are reported at market value. Its plant & equipment has a fair value of $6,000,000, land has a fair value of $2,500,000, and long-term liabilities have a fair value of $5,500,000. The accountants have identified the following possible intangible assets attributed to Bellnorth but not currently recorded on its balance sheet:

	Fair value
Skilled workforce	$1,500,000
Internet domain name	500,000
Customer relationships (not contractual)	1,000,000
Customer order backlog	400,000

A&T issues 200,000 shares of stock with a par value of $10/share and a market value of $100/share for Bellnorth. Registration and issue fees are $300,000, and out of pocket merger costs are $800,000, all paid in cash.

Required
Present A&T's journal entry to record the acquisition.

ANS:

Cash		1,000,000	
Receivables		2,000,000	
Inventories		3,000,000	
Investments		500,000	
P&E		6,000,000	
Land		2,500,000	
Internet domain name		500,000	
Customer order backlog		400,000	
Goodwill		11,600,000	
Merger expenses		800,000	
	Current liabilities		2,000,000
	Long-term liabilities		5,500,000
	Common stock		2,000,000
	Additional paid-in capital		17,700,000
	Cash		1,100,000

9. **Topic: Earnings contingency**
LO 1
The following earnout was the total consideration paid by Oracle Corporation to acquire Pillar Data Systems in fiscal 2012:

Oracle agreed to pay the former owners of Pillar three times total operating income earned over the next three years. The payment, if any, would be made at the end of three years. Oracle originally reported the earnout at $346 million.

Required

a. Assume Oracle used a discount rate of 12% to record the earnout at the date of acquisition. What did Oracle expect total operating income over the next three years to be? Round your answer to the nearest million.
b. What factors determined the discount rate used in requirement a.?
c. Oracle estimated the fair value of Pillar's identifiable net assets to be $132 million at the date of acquisition. How did the existence of the earnout affect the entry Oracle made to record the acquisition?
d. During fiscal 2012, the value of the earnout increased to $368 million due to the passage of time. How did Oracle record this increase in value?

ANS:

a. Let E = expected operating income
$\$346 = 3E/(1.12)^3$
E = $162 million

b. The discount rate should be the risk-free rate adjusted for the uncertainty connected with the payout. Factors include the current prime rate and variability in expected future performance, which is a function of the predicted risk associated with economic variables impacting the company's ability to perform.

c. Without the earnout, no consideration was paid and Oracle would have reported a bargain gain of $132 million. Since the earnout was valued at $346 million, Oracle reported goodwill of $214 million (= $346 - $132 million).

d. The passage of time is a subsequent event. The entry is as follows *(in millions)*:

Loss (income)		22	
	Earnout liability		22

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10. **Topic: Assets and liabilities acquired, goodwill and bargain gain, contingent consideration, changes in consideration value**
LO 1, 2, 3, 4
Here are the pre-acquisition balance sheets of Pepper Company and Salt Company on December 31, 2014:

	Pepper Co.	Salt Co.	
	Book value	**Book value**	**Market value**
Current assets	$ 5,000,000	$ 2,000,000	$ 1,500,000
Investments	1,000,000	500,000	500,000
Land	10,000,000	5,000,000	6,000,000
Buildings (net)	40,000,000	25,000,000	16,000,000
Equipment (net)	25,000,000	10,000,000	2,000,000
Total assets	$81,000,000	$42,500,000	
Current liabilities	$ 4,000,000	$ 1,500,000	1,500,000
Long-term liabilities	20,000,000	10,000,000	12,000,000
Common stock, $10 par	5,000,000	1,000,000	
Additional paid-in capital	40,000,000	20,000,000	
Retained earnings	12,000,000	10,000,000	
Total liabilities & equity	$81,000,000	$42,500,000	

In addition to the above, Salt Co. has identifiable intangibles with a fair value of $5,000,000, not recognized on its books but appropriately capitalized by Pepper.

On January 1, 2015, Pepper issues 400,000 shares of its stock, with a par value of $10/share and a market value of $100/share, to acquire Salt Company's assets and liabilities. Stock registration fees are $1,100,000, paid in cash.

Required

a. Present the journal entry that Pepper makes to record the acquisition.
b. Repeat the requirements of a. above, but now assume Pepper instead issued 100,000 shares of stock for Salt's assets and liabilities, and registration costs are $800,000, paid in cash.
c. Now assume that Pepper issues 100,000 shares for all of Salt's shares, as in requirement b. above, and Pepper agrees to pay cash to Salt's previous owners if the combined earnings of Pepper and Salt exceed a certain threshold over the next two years. The expected present value of the earnings contingency is $8,000,000. Prepare Pepper's acquisition entry.
d. Assume the same facts as in requirement c. Before the contingency period is over, the estimated value of the earnings contingency declines to $5,000,000. Prepare Pepper's entry to reflect the change in value of the earnings contingency, if (1) the value decline occurs within the measurement period, or (2) the value decline is due to events occurring subsequent to acquisition.

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ANS:

a.

Current assets		1,500,000	
Investments		500,000	
Land		6,000,000	
Buildings		16,000,000	
Equipment		2,000,000	
Identifiable intangibles		5,000,000	
Goodwill		22,500,000	
	Current liabilities		1,500,000
	Long-term liabilities		12,000,000
	Common stock		4,000,000
	Additional paid-in capital		34,900,000
	Cash		1,100,000

b.

Current assets		1,500,000	
Investments		500,000	
Land		6,000,000	
Buildings		16,000,000	
Equipment		2,000,000	
Identifiable intangibles		5,000,000	
	Current liabilities		1,500,000
	Long-term liabilities		12,000,000
	Common stock		1,000,000
	Additional paid-in capital		8,200,000
	Cash		800,000
	Gain on acquisition		7,500,000

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c.

Current assets		1,500,000	
Investments		500,000	
Land		6,000,000	
Buildings		16,000,000	
Equipment		2,000,000	
Identifiable intangibles		5,000,000	
Goodwill		500,000	
	Current liabilities		1,500,000
	Long-term liabilities		12,000,000
	Earnings contingency liability		8,000,000
	Common stock		1,000,000
	Additional paid-in capital		8,200,000
	Cash		800,000

d.

(1)

Earnings contingency liability		3,000,000	
	Goodwill		500,000
	Gain on acquisition		2,500,000

(2)

Earnings contingency liability		3,000,000	
	Gain on reduction in liability		3,000,000

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11. **Topic: Valuation of assets and liabilities acquired, stock acquisition, goodwill, stock price contingency**
LO 1, 2
Below is the condensed balance sheet of Sarna, Inc., along with estimates of fair values. Podega, Inc. is planning to acquire Sarna by issuing 100,000 shares of its $1 par value common stock (market value $8/share) in exchange for all the outstanding common stock of Sarna. Podega also guarantees the value of its shares issued. The expected present value of this stock price contingency is $200,000.

Sarna, Inc.
Pre-Combination Condensed Balance Sheet

	Book value	Fair value
Current assets	$ 380,000	$ 350,000
Plant assets	740,000	810,000
Total assets	$1,120,000	
Liabilities	$ 500,000	450,000
Common stock	50,000	
Additional paid-in capital	170,000	
Retained earnings	400,000	
Total liabilities and equity	$1,120,000	

Required
a. Prepare Podega's entry to record the acquisition as a statutory merger.
b. Prepare Podega's entry to record the acquisition as a stock acquisition.

ANS:

a.

Current assets		350,000	
Plant assets		810,000	
Goodwill		290,000	
	Liabilities		450,000
	Common stock, par		100,000
	APIC		700,000
	APIC-stock price contingency		200,000

b.

Investment in S		1,000,000	
	Common stock, par		100,000
	APIC		700,000
	APIC-stock price contingency		200,000

12. **Topic: Goodwill, in-process research and development**
LO 1, 5

Philips Company paid $15,000,000 in cash for the net assets of Schweiz Corporation, in a statutory merger. Schweiz's net assets have a book value of $6,000,000. The fair values of Schweiz's assets and liabilities approximate their book values, except as noted below.

	Book value Dr(cr)	**Fair value Dr(cr)**
Inventory	$ 400,000	$300,000
Land	300,000	800,000
Building, net	800,000	200,000
Equipment, net	600,000	450,000
Patents	100,000	500,000
Long-term debt	(500,000)	(480,000)

Schweiz Corporation has in-process research and development projects with a current market value of $300,000.

Required

Prepare a schedule to calculate the goodwill arising from this acquisition.

ANS:

Price paid		$15,000,000
Book value		6,000,000
Excess		$9,000,000
Fair value – book value:		
Inventory	$ (100,000)	
Land	500,000	
Buildings	(600,000)	
Equipment	(150,000)	
Patents	400,000	
In-process R&D	300,000	
Long-term debt	20,000	370,000
Goodwill		$8,630,000

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13. **Topic: Bargain gain, preacquisition contingency**
LO 4, 5
Petrochina Company acquired Swire Pacific Company in a statutory merger by issuing long-term debt valued at $1,000,000. Book and fair values of Swire Pacific's net assets are as follows at the date of acquisition:

	Book value Dr(cr)	**Fair value Dr(cr)**
Investments	$ 150,000	$ 150,000
Inventory	400,000	410,000
Land	300,000	400,000
Buildings	600,000	750,000
Equipment	100,000	20,000
Liabilities	(650,000)	(650,000)

Petrochina determines that Swire Pacific is a defendant in a pending lawsuit. It is appropriate to recognize this lawsuit at a value of $40,000.

Required
a. Prepare a schedule to calculate the gain on acquisition.
b. Prepare Petrochina's journal entry to record the acquisition.

ANS:

a.

Price paid		$1,000,000
Fair value of net assets acquired:		
Investments	150,000	
Inventory	410,000	
Land	400,000	
Buildings	750,000	
Equipment	20,000	
Reported liabilities	(650,000)	
Lawsuit liability	(40,000)	1,040,000
Gain on acquisition		$ (40,000)

b.

Investments		150,000	
Inventory		410,000	
Land		400,000	
Buildings		750,000	
Equipment		20,000	
	Liabilities		1,690,000
	Gain on acquisition		40,000

Note: Liabilities = $650,000 + $40,000 + $1,000,000

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14. **Topic: Preacquisition contingency, subsequent value changes**
LO 3, 5
Ping Company acquires all of Sun Corp. in an asset acquisition. Ping paid $10,000,000 more than Sun's book value, and this excess was attributed entirely to goodwill, as all of Sun's assets and liabilities were carried at amounts equivalent to fair value. At the time of the combination, a lawsuit was pending against Sun, which Sun had not recorded on its books. It was felt at the time that Sun would win the lawsuit, so no provision for it was made when Ping recorded the asset acquisition.

Required

a. Six months after the acquisition, new information reveals that the expected value of the lawsuit at the date of acquisition was $4,000,000. Make the appropriate entry on Ping's books to record this new information.

b. Assume the same information as above, except that the value change is a result of events occurring subsequent to acquisition. Make the appropriate entry on Ping's books to record the new information.

ANS:

a.

Goodwill		4,000,000	
	Estimated lawsuit liability		4,000,000

b.

Loss on lawsuit		4,000,000	
	Estimated lawsuit liability		4,000,000

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15. **Topic: Assets and liabilities acquired, acquisition costs, preacquisition contingency, change in estimate**
LO 1, 2, 3, 5
On July 1, 2014, P Company acquired all of the assets and liabilities of S Company. P Company issued 100,000 shares of common stock with a par value of $10/share, market value $60/share. Attorney fees were $150,000 and stock registration fees were $400,000. Financial information on P and S, just prior to the combination, appears below:

	P Company	**S Company**	
	Book value	**Book value**	**Market value**
Current assets	$ 3,000,000	$ 1,000,000	$ 1,100,000
Investment in HTM securities		250,000	1,000,000
Land	5,000,000	3,000,000	4,000,000
Plant & equipment, net	11,000,000	7,000,000	9,000,000
Total assets	$19,000,000	$11,250,000	
Current liabilities	$ 2,500,000	$ 2,000,000	2,000,000
Long-term liabilities	8,500,000	7,250,000	8,000,000
Common stock	500,000	200,000	
Additional paid-in capital	3,500,000	1,050,000	
Retained earnings	4,000,000	750,000	
Total liabilities & equity	$19,000,000	$11,250,000	

Required

a. Prepare P's balance sheet immediately following the merger.

b. After the acquisition has been recorded, P Company discovers that S Company has an unrecorded liability for underpayment of taxes in the amount of $1,000,000. Prepare the necessary journal entry to record this discovery, assuming:

(1) the discovery occurs within the measurement period.

(2) the discovery occurs after the measurement period is over.

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ANS:

a.

P Company
Balance Sheet
as of July 1, 2014

Current assets	$ 3,550,000
Investment in HTM securities	1,000,000
Land	9,000,000
Plant & equipment, net	20,000,000
Goodwill	900,000
Total assets	$34,450,000
Current liabilities	$ 4,500,000
Long-term liabilities	16,500,000
Common stock	1,500,000
Additional paid-in capital	8,100,000
Retained earnings	3,850,000
Total liabilities & equity	$34,450,000

Entry (not required):

Current assets		1,100,000	
Investments		1,000,000	
Land		4,000,000	
P&E		9,000,000	
Goodwill		900,000	
Merger expenses		150,000	
	Current liabilities		2,000,000
	Long-term liabilities		8,000,000
	Common stock		1,000,000
	Additional PIC		4,600,000
	Cash		550,000

b.

(1)

Goodwill		1,000,000	
	Tax liability		1,000,000

(2)

Loss		1,000,000	
	Tax liability		1,000,000

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16. **Topic: Stock price contingency**
LO 2
Netcom acquires all of the voting shares of Unicom by issuing 25,000,000 shares of no-par common stock valued at $400,000,000 plus cash of $50,000,000 and records the acquisition as a stock acquisition. Included in the agreement is a contingency guaranteeing the former shareholders of Unicom that Netcom's shares will be worth at least $350,000,000 after one year. If not, Unicom will issue additional shares to bring the total value of shares issued to $350,000,000. This contingency is valued at $20,000,000 at the date of acquisition. At the end of the first year following the acquisition, the 25,000,000 shares of Netcom's stock held by the former shareholders of Unicom are worth $12/share.

Required

a. Prepare Netcom’s journal entry to initially record the acquisition.
b. How many additional shares must Netcom subsequently issue to the former shareholders of Unicom?
c. Prepare Netcom’s journal entry to record the issuance of the additional shares.

ANS:

a.

Investment in S		470,000,000	
	Capital stock		400,000,000
	Cash		50,000,000
	APIC-stock price contingency		20,000,000

b. $350,000,000 – ($12 x 25,000,000) = $50,000,000/$12 = 4,166,667 additional shares

c. The contingency was originally recorded in equity at the amount of $20,000,000. However, changes in the value of stock price contingencies do not affect the acquisition price or income. Any changes in value are adjustments in equity.

APIC-stock price contingency		20,000,000	
APIC-other		30,000,000	
	Capital stock		50,000,000

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17. **Topic: Calculation of goodwill**
LO 1, 2
HPAR pays $5,000 million in cash and issues 500 million shares of stock with a par value of $0.10/share and fair value of $40/share to acquire 4BOGEY's assets and liabilities on January 1, 2014. Balance sheets ***just prior to the acquisition*** are as follows *(in millions)*:

	HPAR	4BOGEY	
	Book value	**Book value**	**Fair value**
Current assets	$ 7,000	$ 1,000	$ 2,100
Property, plant & equipment, net	55,000	5,000	3,000
Identifiable intangible assets	400	2,000	7,000
Total assets	$ 62,400	$ 8,000	
Current liabilities	$ 6,500	$ 800	$ 1,000
Long-term debt	30,000	6,000	5,800
Common stock, par value	200	700	
Additional paid-in capital	22,000	1,800	
Retained earnings	4,000	4,000	
Accumulated other comprehensive income	100	(500)	
Treasury stock	(400)	(4,800)	
Total liabilities & equity	$ 62,400	$ 8,000	

HPAR's consultants find these items that are not reported on 4BOGEY's balance sheet:

	Fair value
Potential contracts with new customers	$ 4,000
Advanced production technology	2,000
Future cost savings	1,000
Contractual obligations – long-term warranties	600

Outside consultants are paid $40 million in cash, and registration fees to issue the new stock are $200 million. To sweeten the deal, HPAR agrees to pay the former shareholders of 4BOGEY an additional cash amount of $10,000 million at the end of 2012 that depends on the 2014-15 reported EBITDA of 4BOGEY. HPAR believes there is a 25% chance that this payment will have to be made, and the appropriate discount rate for the earnout is 20%.

Required
Calculate the goodwill that should be reported on this acquisition *(in millions)*. If necessary, round numbers to the nearest million.

ANS:

Cash to former shareholders		$ 5,000
Market value of stock to former shareholders	500 x $40	20,000
Earnout	$(10,000 \times 25\%)/(1.20)^2$	1,736
Total acquisition cost		26,736
Book value		(1,200)
Excess of acquisition cost over book value		25,536
Fair value – book value of identifiable net assets acquired:		
Current assets	1,100	
Property, plant & equipment	(2,000)	
Identifiable intangibles on 4BOGEY's books	5,000	
Previously unreported intangibles-technology	2,000	
Current liabilities	(200)	
Long-term debt	200	
Previously unreported warranty obligations	(600)	(5,500)
Goodwill		$ 20,036

18. **Topic: Recognition of acquired intangibles, goodwill**
LO 1
ABC Services provides web services to professional services organizations. ABC acquires XYZ Consulting to broaden its service offerings, at a cost of $3,000,000. The book values of XYZ's recorded net assets (all tangibles) are $300,000, and their fair values are $500,000. XYZ also possesses the following unrecorded intangibles, with fair values as listed:

	Fair value
Registered company name	$1,000,000
Customer contracts	200,000
Long-time customer relationships	700,000
Lease agreements	250,000
Internet domain names	900,000
Skilled work force	800,000

Required
Prepare a schedule to calculate the goodwill recognized for this acquisition.

ANS:

Identifiable intangibles arising from contractual or other legal rights, or separable intangibles, are capitalized by the acquirer. The registered name, customer contracts, lease agreements and internet domain names meet these requirements.

Acquisition cost	$ 3,000,000
Book value	(300,000)
Excess of cost over book value	$ 2,700,000
Allocated to:	
Tangible net assets	200,000
Company name	1,000,000
Customer contracts	200,000
Lease agreements	250,000
Internet domain names	900,000
Total allocated to tangible and identifiable intangible net assets	2,550,000
Goodwill	$ 150,000

19. **Topic: Subsequent changes in acquired asset values**
LO 3

Assume Co. X acquires Co. Y, and the price paid was well in excess of the fair values of the identifiable net assets of Y. Co. X determined that Co. Y had developed technology with a fair value of $5,000,000 at the date of acquisition, not reported on Co. Y's balance sheet. Later, it is determined that this developed technology has a fair value of zero.

Required

a. Describe the reporting standard for subsequent value changes of acquired assets.

b. Co. X is motivated to conclude that the value change occurred within the measurement period, rather than after the measurement period is over. Why?

ANS:

a. If the value change is the result of new information that provides a more accurate value of the asset as of the date of acquisition, and the new information is acquired within one year of the date of acquisition, the new information is treated as a correction of the original acquisition entry. If the value change is the result of events occurring subsequent to the acquisition, the change is reported in income.

b. If the discovery is made within the measurement period, the dr. will be to goodwill, and the impact on income is delayed, perhaps indefinitely if the goodwill does not become impaired in future years. If the discovery is due to subsequent events, the dr. will be to a loss account, which immediately reduces income by the full $5,000,000.

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20. **Topic: Identification of acquiring company, valuation implications**
LO 1

Company A's assets are carried on the books at less than market value. Company B's assets are carried on the books at more than market value. A and B want to combine, and are contemplating how to go about it. One alternative is to have A purchase B. Another is to have B purchase A. A third alternative is for independent investors to form a new company, Company C, which would then purchase both A and B.

Required

Determine the impact on future combined net income of the three alternatives, holding everything constant except the *form* of the acquisition.

ANS:

Although there are three alternatives listed, there are actually only two: either A is the acquirer, or B is the acquirer. If a new company is formed, one of the existing companies is identified as the acquirer for purposes of recording the acquisition.

If A is the acquirer, its net assets are not revalued upwards, and B's net assets are revalued downwards, with a net effect of reducing combined assets. Subsequent write-offs are similarly reduced, increasing future income.

If B is the acquirer, its net assets are not revalued downward, and A's net assets are revalued upward, with a net effect of increasing combined assets. Subsequent write-offs increase, reducing future income.

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